



# San Francisco Law Library

436 CITY HALL

No. 148033

---

## EXTRACT FROM RULES


Rule 1a. Books and other legal material may be borrowed from the San Francisco Law Library for use within the City and County of San Francisco, for the periods of time and on the conditions hereinafter provided, by the judges of all courts situated within the City and County, by Municipal, State and Federal officers, and any member of the State Bar in good standing and practicing law in the City and County of San Francisco. Each book or other item so borrowed shall be returned within five days or such shorter period as the Librarian shall require for books of special character, including books constantly in use, or of unusual value. The Librarian may, in his discretion, grant such renewals and extensions of time for the return of books as he may deem proper under the particular circumstances and to the best interests of the Library and its patrons. Books shall not be borrowed or withdrawn from the Library by the general public or by law students except in unusual cases of extenuating circumstances and within the discretion of the Librarian.

Rule 2a. No book or other item shall be removed or withdrawn from the Library by anyone for any purpose without first giving written receipt in such form as shall be prescribed and furnished for the purpose, failure of which shall be ground for suspension or denial of the privilege of the Library.

Rule 5a. No book or other material in the Library shall have the leaves folded down, or be marked, dog-eared, or otherwise soiled, defaced or injured, and any person violating this provision shall be liable for a sum not exceeding treble the cost of replacement of the book or other material so treated and may be denied the further privilege of the Library.







Digitized by the Internet Archive  
in 2010 with funding from  
Public.Resource.Org and Law.Gov









No. 12610

2653

**United States**  
**Court of Appeals**  
for the Ninth Circuit.

---

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner,

vs.

BURNHAM ENERSEN and NINA W. ENER-  
SEN,

Respondents.

---

**Transcript of Record**

---

**Petitions to Review Decisions of the Tax Court  
of the United States**

**FILED**

NOV - 1 1950

PAUL P. O'BRIEN,

CLERK





No. 12610

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner,

vs.

BURNHAM ENERSEN and NINA W. ENER-  
SEN,

Respondents.

---

Transcript of Record

---

Petitions to Review Decisions of the Tax Court  
of the United States





## INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

	PAGE
Answer .....	21
Appearances .....	1
Certificate of Clerk.....	93
Decision No. 20978.....	77
Decision No. 20979.....	78
Docket Entries No. 20978.....	2
Docket Entries No. 20979.....	4
Exhibits, Joint:	
1-A—Memorandum by Participant—1940.	35
2-B—Memorandum by Participant—1941.	37
3-C—Memorandum by Participant—1942.	39
4-D—Memorandum by Participant—1943.	42
Exhibits, Respondent's:	
E—Tax Return for 1944.....	47
F—Tax Returns for 1945.....	58
Memorandum Findings of Fact and Opinion..	71
Motion for Extension of Time to Prepare Record on Review.....	88

INDEX	PAGE
Notice as to Statement of Points to Be Relied Upon and as to Parts to Be Printed.....	95
Order Enlarging Time.....	89
Petition .....	6
Exhibit A—Notice of Deficiency.....	13
Petition for Review No. 20978.....	79
Notice of Filing Petition for Review....	81, 82
Petition for Review No. 20979.....	83
Notice of Filing Petition for Review....	86, 87
Proceedings .....	32
Opening Statement on Behalf of Peti- tioners .....	32
Opening Statement on Behalf of Respond- ent .....	44
Statement of Points.....	90
Statement Re Diminution of Record.....	92
Stipulation of Facts.....	23
Stipulation as to Parts of the Record to Be Printed .....	96

Docket No. 20978

BURNHAM ENERSEN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

APPEARANCES

For Petitioner:

HENRY D. COSTIGAN, ESQ.,

STANLEY MORRISON, ESQ.,

GORDON M. WEBER, ESQ.

For Respondent:

EARL C. CROUTER, ESQ.

## DOCKET ENTRIES

1948

Nov. 16—Petition received and filed. Taxpayer notified. Fee paid.

Nov. 18—Copy of petition served on General Counsel.

Nov. 16—Request for Circuit hearing in San Francisco, filed by taxpayer. 11/22/48. Granted.

Dec. 21—Answer filed by General Counsel.

Dec. 27—Copy of answer served on taxpayer. San Francisco calendar.

1949

Sept. 9—Hearing set Nov. 7, 1949—San Francisco, California.

Nov. 7—Hearing had before Judge Harron on merits. Consolidated with Dkt. 20979 for hearing. (Submitted by stipulation of facts.) Stipulation of facts with Joint Exhibits 1-A thru 4-D attached thereto, filed. Briefs due 12/28/49. Replies 1/26/50.

Dec. 7—Transcript of hearing 11/7/49 filed.

Dec. 21—Brief filed by General Counsel.

Dec. 22—Brief filed by taxpayer. Copy served.



1950

Jan. 20—Reply brief filed by taxpayer. Copy served.

Jan. 25—Reply brief filed by General Counsel.

Jan. 26—Memorandum findings of fact and opinion rendered, Judge Harron. Decision will be entered that there are no deficiencies. Copy served.

Jan. 27—Decision entered. Judge Harron. Div. 13.

Apr. 21—Petition for review by U. S. Court of Appeals, 9th Circuit, with assignments of error filed by General Counsel.

May 5—Proof of service of petition for review filed. (Taxpayer.)

May 5—Proof of service of petition for review filed. (Counsel for Taxpayer.)

May 24—Motion for extension to July 20, 1950, to prepare and transmit the record filed by General Counsel.

May 24—Order enlarging time to July 20, 1950, to prepare and transmit the record, entered.

July 3—Statement of points filed by General Counsel with service acknowledged thereon.

July 3—Statement re diminution of record filed by General Counsel with service acknowledged thereon.

Docket No. 20979

NINA W. ENERSEN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## DOCKET ENTRIES

1948

Nov. 16—Petition received and filed. Taxpayer notified. Fee paid.

Nov. 18—Copy of petition served on General Counsel.

Nov. 16—Request for Circuit hearing in San Francisco, filed by taxpayer. 11/22/48 Granted.

Dec. 21—Answer filed by General Counsel.

Dec. 27—Copy of answer served on taxpayer. San Francisco calendar.

1949

Sept. 9—Hearing set Nov. 7, 1949 in San Francisco, California.

Nov. 7—Hearing had before Judge Harron on merits. Consolidated with Dkt. 20978. (Submitted by Stipulation of Facts.) Stipulation of facts filed at hearing with joint Exhibits 1-A thru 4-D attached thereto. Briefs due 12/28/49. Replies 1/26/50.

Dec. 7—Transcript of hearing 11/7/49 filed.

Dec. 21—Brief filed by General Counsel.

Dec. 22—Brief filed by taxpayer. Copy served.

1950

Jan. 20—Reply brief filed by taxpayer. Copy served.

Jan. 25—Reply brief filed by General Counsel.

Jan. 26—Memorandum findings of fact and opinion rendered, Judge Harron. Decision will be entered that there are no deficiencies. Copy served.

Jan. 27—Decision entered. Judge Harron. Div. 13.

Apr. 21—Petition for review by U. S. Court of Appeals, 9th Circuit, with assignments of error filed by General Counsel.

May 5—Proof of service of petition for review on taxpayer filed.

May 5—Proof of service of petition for review on counsel for taxpayer filed.

May 24—Motion for extension to July 20, 1950, to prepare and transmit record filed by General Counsel.

May 24—Order enlarging time to July 20, 1950, to prepare and transmit record, entered.

July 3—Statement of points filed by General Counsel with service acknowledged thereon.

July 3—Statement re diminution of record filed by General Counsel with service acknowledged thereon.

---

[Title of Tax Court and Cause.]

### PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, San Francisco, IRA:90-D:WBH, dated October 26, 1948, and as a basis of his proceeding alleges as follows:

1. The petitioner is an individual with residence at 2642 Baker Street, San Francisco, California. The returns for the period here involved were filed with the Collector for the First District of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on October 26, 1948.

3. The taxes in controversy are income taxes for the calendar years 1944 and 1945 and in the amounts of \$237.38 for 1944 and \$1,150 for 1945.

4. The determination of the taxes set forth in said notice of deficiency is based upon the following error:

In determining the tax liability of the petitioner for the years 1944 and 1945 the Commissioner



erroneously held that the petitioner could not use the tax computation method set forth in Section 107(a) of the Internal Revenue Code with respect to his taxable share of certain compensation of a partnership of which he was a member, consisting of certain fees for personal services covering in each case a period of thirty-six calendar months or more, which fees were in each case received by said partnership in one taxable year to the extent of at least 80 per centum of the total fees for the said services; such holding was erroneously based on the ground that petitioner had not been a partner in said partnership for thirty-six calendar months or more prior to the dates of receipt of such fees, and upon the erroneous finding that petitioner did not have the right to participate in fees earned by the partnership prior to August 1, 1943.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner became a partner in the law partnership of McCutchen, Thomas, Matthew, Griffiths & Greene on August 1, 1943.

(b) The petitioner and said partnership have both at all times followed the cash receipts and disbursements method of accounting in their tax returns and in any and all books of account kept by said partnership or by petitioner. Both petitioner and said partnership make their tax returns on a calendar year basis and have always done so.

(c) For approximately ten years prior to August 1, 1943, the petitioner had been employed by said partnership as a lawyer.

(d) During the period from January 1, 1940, to August 1, 1943, the petitioner received as his entire compensation in such employment a percentage of the profits of the said partnership. Prior to January 1, 1940, petitioner was paid a salary by said partnership.

(e) During the calendar years 1944 and 1945, the partnership received several amounts from clients for personal services performed over periods of several years. In each of these instances at least 80 per centum of the total compensation for personal services covering a period of thirty-six months or more (from the beginning to the completion of such services) was received by the partnership in a single taxable year.

(f) In so far as it is legal to do so, all fees received by any member of said partnership in any calendar month are pooled in a single fund which is first used to pay all expenses of such month, and the balance is then or at the end of the year divided among all of the partners and all of those employees who are employed on a profit sharing basis. Each such division is in accordance with the percentage shares as agreed upon by the partners and in effect during the month in which the said fees are received. Partners and profit-sharing employees share in such division of all fees received while

they are entitled to a share in the partnership profits; conversely, when partners or employees cease to be such by death or retirement or otherwise, they do not share in fees received after the month in which the cessation occurs.

(g) The fee division procedure outlined in paragraph (f) has been followed by the said partnership for many years and at all times herein mentioned.

(h) In accordance with said procedure described in paragraph (f) above each of the fees described in paragraph (e) above was divided among all partners and employees entitled to share in profits at the time of its receipt.

(i) From such division of those certain fees described in paragraph (e) above the petitioner received \$3,561.13 in 1944 and \$10,791.68 in 1945.

(j) Petitioner was married in 1935. Petitioner and his wife resided in California at all times herein mentioned, including all of 1944 and 1945. Said amounts received by petitioner as alleged in paragraph (i) above constituted community property.

(k) Petitioner computed his income taxes for each of the years 1944 and 1945 by first allocating his partnership share of each of the fees described in paragraph (e), above (aggregating the amounts alleged in paragraph (i), above), received in such taxable year (1944 or 1945 as the case might be)



ratably over that part of the period during which the services for which it was received were performed which preceded the date of receipt of such fee. Petitioner next treated as his income his community property half of each total amount so allocated to each of the years 1935 to 1945, inclusive, and all of each total amount so allocated to each of the years 1931 to 1934, inclusive, in each such case treating it as income for the year to which so allocated. (In view of the fact that all of said partnership share constituted community property, because received in 1944 or 1945, after petitioner's marriage, it may be that petitioner should have treated as his income only one-half of each of the amounts so allocated to 1931-34; however, because of the small amounts involved, this would not change the aggregate taxes attributable to these years, 1931-34, for both petitioner and his wife.) Petitioner then determined the taxes attributable to such amounts when so treated as his income for such years 1931-45 and substituted the aggregate of the taxes so attributable thereto for the tax which would otherwise have been payable on account of receipt of the said fees during the taxable year of receipt (1944 or 1945, as the case might be).

(1) In following the procedure outlined in paragraph (k) above, petitioner's portion of the part of said partnership share allocated to each year was as follows:



	From Fees Rec'd in 1944	From Fees Rec'd in 1945
1945 .....	\$ ....	\$ 849.78
1944 .....	141.98	1,508.42
1943 .....	403.26	1,508.41
1942 .....	403.25	699.16
1941 .....	391.42	59.36
1940 .....	346.45	76.62
1939 .....	94.20	82.50
1938 .....	....	78.91
1937 .....	....	78.91
1936 .....	....	78.91
1935 .....	....	78.91
1934 .....	....	157.83
1933 .....	....	157.83
1932 .....	....	157.83
1931 .....	....	118.98
	<hr/>	<hr/>
	\$1,780.56	\$5,691.76

Wherefore, the petitioner prays that this court may hear the proceeding and determine that there are no deficiencies due from the petitioner for the years 1944 or 1945.

/s/ HENRY D. COSTIGAN,

/s/ STANLEY MORRISON,

/s/ GORDON M. WEBER,

Counsel for Petitioner.

State of California,  
City and County of San Francisco—ss.

Burnham Enersen, being duly sworn, says that he is the petitioner above named; that he has read the foregoing petition or had the same read to him, and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be on information and belief, and that those he believes to be true.

/s/ BURNHAM ENERSEN.

Subscribed and sworn to before me this 8th day of November, 1948.

[Seal]      /s/ EVA L. NELSON,  
Notary Public in and for the City and County of  
San Francisco, State of California.

EXHIBIT A

Form 1230 (Rev. Sept. 1945)

SN-IT-1

Treasury Department  
Internal Revenue Service  
74 New Montgomery Street  
San Francisco 5, California

Oct. 26, 1948.

Office of  
Internal Revenue Agent in Charge  
San Francisco Division  
IRA:90-D:WBH

Mr. Burnham Enersen  
2642 Baker Street  
San Francisco, California

Dear Mr. Enersen:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1944, and December 31, 1945, discloses a deficiency of \$1,387.38 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Saturday, Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington 25, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, San Francisco 5, California—for the attention of Conference Section. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

GEO. J. SCHOENEMAN,  
Commissioner.

By /s/ F. M. HARLESS,  
Internal Revenue Agent in  
Charge .

Enclosures:

Statement  
Form 1276  
Form 870

Statement

San Francisco  
IRA :90-D:WBH

Mr. Burnham Enersen  
2642 Baker Street  
San Francisco, California

Tax Liability for the Taxable Years Ended December 31, 1944, and December 31, 1945.



Year	Deficiency
1944 Income Tax .....	\$ 237.38
1945 Income Tax .....	1,150.00
	<hr/>
Total .....	\$1,387.38

In making this determination of your income tax liability, careful consideration has been given to your protest filed May 14, 1948, and to the statements made at the conferences held on June 11, 1948, and August 4, 1948.

A copy of this letter and statement has been mailed to your representatives, Messrs. Henry D. Costigan, Stanley Morrison and Gordon M. Weber, 351 California Street, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

#### Adjustments to Net Income

Year: 1944

Net income as disclosed by return ..... \$5,739.21

No change is made in the net income reported  
on the return.

## Explanation of Adjustments

(a) It is noted that distributive income from the law partnership, McCutcheon, Thomas, Matthew, Griffiths and Greene, San Francisco, California, was reported on your return as follows:

	Amount allocated to to prior years under section 107(a) Internal Revenue Code	Balance	Total dis- tributive share
Distributive income .....	\$3,277.17	\$9,020.49	\$12,297.66
Your 1/2 community share .....	\$1,638.58	\$4,510.25	\$ 6,148.83

In computing your tax liability for the taxable year 1944 you deducted \$237.38 representing reduction in tax due to application of section 107(a) of the Internal Revenue Code, as shown below:

Tax on entire income at 1944 rates		
(including \$1,638.58 fees) .....		\$1,189.37
Adjusted gross income .....	\$6,239.21	
Less: Fees allocated to prior years .....	1,638.58	
Revised adjusted gross income .....	\$4,600.63	
Tax on \$4,600.63 (per Tax Table) .....		766.00
Portion of 1944 tax attributable to income allocated to prior years .....		\$ 423.37

Tax on income allocated to prior years:

Year	Income	Tax	
1943.....	\$ 403.26	\$ 97.99	
1942.....	403.25	21.57	
1941.....	391.42	49.32	
1940.....	346.45	13.72	
1939.....	94.20	3.39	
	<u>\$1638.58</u>	<u>\$185.99</u>	185.99

Reduction in tax by application of section 107(a) .....\$ 237.38

During the taxable year the partnership received fees of \$96,158.33 for services rendered over a period of 36 calendar months or more, the amount in each instance representing more than 80% of the total compensation for the services rendered. You reported the amount of \$3,561.13 as your distributive share of which \$3,277.17 was attributed to services in prior years and \$283.96 was applied to services in the taxable year 1944.

It is disclosed that from the year 1933 you were employed by the partnership on a straight salary basis and from January 1, 1940, you

Explanation of Adjustments—(Continued)

received a small percentage of the profits in addition to your salary; and on August 1, 1943, you were admitted as a partner participating in the profits and losses according to your pro rata share.

It is held that prior to August 1, 1943, you were an employee of the partnership and did not have the right to participate in fees earned by the partnership prior to that date. Since the period of your membership in the partnership is less than 36 calendar months, it is held that you do not qualify for relief under the provisions of section 107(a) of the Internal Revenue Code with respect to the fees earned since August 1, 1943. The reduction of \$237.38 in tax is, therefore, disallowed.

Computation of Tax  
Year: 1944

Net income .....	\$5,739.21	
Less: Surtax exemption .....	1,000.00	
	<hr/>	
Surtax net income .....	\$4,739.21	
	<hr/>	
Surtax on \$4,739.21 .....		\$1,032.19
Net income .....	\$5,739.21	
Less: Normal tax exemption .....	500.00	
	<hr/>	
Normal tax net income .....	\$5,239.21	
	<hr/>	
Normal tax, 3% of \$5,239.21 .....		157.18
		<hr/>
Total tax .....		\$1,189.37
(a) Less: Reduction under section 107(a) of the Internal Revenue Code .....		0.00
		<hr/>
Correct income tax liability .....		\$1,189.37
Income tax disclosed by return, page 1 - line 6 (Original, Account No. 7714308 First California District) ..		951.99
		<hr/>
Deficiency of income tax .....	\$	237.38

## Adjustments to Net Income

Year: 1945

Net income as disclosed by return .....	\$14,699.40
No change is made in the net income reported on the return.	

## Explanation of Adjustments

(a) Your distributive share of income from the partnership McCutcheon, Thomas, Matthew, Griffiths and Greene, San Francisco, California, was reported on your return as follows:

	Amount allocated to prior years under section 107 (a) Internal Revenue Code	Balance	Total dis- tributive share
Distributive income .....	\$9,092.12	\$21,398.00	\$30,490.12
Wife's 1/2 community share (since 1935) .....	\$4,250.14	\$10,994.92	\$15,245.06
Your share .....	\$4,841.98	\$10,403.08	\$15,245.06

In computing your tax liability for the taxable year 1945 you deducted \$1,150.00 representing reduction in tax due to the application of section 107 (a) of the Internal Revenue Code, as shown below:

Tax on entire income at 1945 rates (including fees of \$4,841.98) .....	\$4,556.72
Net income .....	\$14,699.40
Less: Fees allocated to prior years .....	4,841.98
Revised net income .....	\$ 9,857.42
Tax on \$9,857.42—1945 rates .....	2,532.24
Portion of 1945 tax attributable to income allocated to prior years .....	\$2,024.48



## Explanation of Adjustments—(Continued)

Brought forward .....\$2,024.48

## Tax on income allocated to prior years:

Year	Income	Tax
1944.....	\$1,508.42	\$385.62
1943.....	1,508.41	403.80
1942.....	699.16	37.41
1941.....	59.36	7.48
1940.....	76.62	6.21
1939.....	82.50	2.97
1938.....	78.91	2.84
1937.....	78.91	2.84
1936.....	78.91	2.84
1935.....	78.92	2.84
1934.....	157.83	5.68
1933.....	157.83	6.31
1932.....	157.83	6.31
1931.....	118.37	1.33

\$4,841.98      \$874.48

874.48

Reduction in tax by application of section 107(a) .....\$1,150.00

During the taxable year 1945 the partnership received fees of \$178,-375.00 for services rendered over a period of 36 calendar months or more, the amount in each instance representing more than 80% of the total compensation for the services rendered. Your distributive share of the fees was \$10,791.68 of which \$1,699.56 was attributed to services for the taxable year 1944, and \$9,092.12 was allocated to services in prior years.

For the reasons stated in item (a) for the taxable year 1944, it is held that you do not qualify for relief under the provisions of section 107(a) of the Internal Revenue Code. The reduction of \$1,150.00 in tax is, therefore, disallowed.

Computation of Tax  
Year: 1945

Net income .....	\$14,699.40	
Less: Surtax exemption .....	1,000.00	
	<hr/>	
Surtax net income .....	\$13,699.40	
	<hr/>	
Surtax on \$13,699.40 .....		\$4,130.74
Net income .....	\$14,699.40	
Less: Normal tax exemption .....	500.00	
	<hr/>	
Normal tax net income .....	\$14,199.40	
	<hr/>	
Normal tax, 3% of \$14,199.40 .....		425.98
		<hr/>
Total tax .....		\$4,556.72
(a) Less: Reduction under section 107(a) of the Internal Revenue Code .....		0.00
		<hr/>
Correct income tax liability .....		\$4,556.72
Income tax disclosed by return, page 1 - line 6 (Original, Account No. 3019467 First California District) ..		3,406.72
		<hr/>
Deficiency of income tax .....		\$1,150.00

Received and Filed T.C.U.S. November 16, 1948.

Served November 18, 1948.

[Title of Tax Court and Cause.]

Docket No. 20978

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1, 2, 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4. Denies that the determination of tax set forth in the notice of deficiency is based upon error as alleged in paragraph 4 of the petition.

5(a) Admits the allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b) For lack of knowledge or information sufficient to form a belief, denies the allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) Admits the allegations contained in subparagraph (c) of paragraph 5 of the petition.

(d) Admits that prior to January 1, 1940, the petitioner was paid a salary by the partnership; denies the remaining allegations contained in subparagraph (d) of paragraph 5 of the petition.

(e) Admits the allegations contained in subparagraph (e) of paragraph 5 of the petition.

(f), (g), (h) For lack of knowledge or information sufficient to form a belief, denies the allegations contained in subparagraphs (f), (g) and (h) of paragraph 5 of the petition.

(i) Denies the allegations contained in subparagraph (i) of paragraph 5 of the petition.

(j) Admits that the petitioner and his wife resided in California during 1944 and 1945; denies the remaining allegations contained in subparagraph (j) of paragraph 5 of the petition.

(k) Admits the allegations contained in subparagraph (k) of paragraph 5 of the petition, except that respondent denies the parenthetical matter set forth in this subparagraph commencing at the last line of page 5 of the petition and ending at line 8 of page 6 thereof.

(l) Denies the allegations contained in subparagraph (l) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ CHARLES OLIPHANT,  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

B. H. NEBLETT,  
Division Counsel.

T. M. MATHER,

W. J. McFARLAND,

Special Attorneys, Bureau of  
Internal Revenue.

Received and Filed T.C.U.S. December 21, 1948.



The Tax Court of the United States  
Dockets No. 20978 and No. 20979

BURNHAM ENERSEN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

NINA W. ENERSEN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties to the above-entitled causes that the facts hereinafter set forth shall be taken to be true and received in evidence in the trial of such cause, subject to the right of either party to introduce other and further evidence not inconsistent with the following facts:

(1) Both of the above-entitled causes involve the same years and identical facts and may be consolidated for purposes of hearing and of opinion. Burnham Enersen, hereinafter referred to as "petitioner," is the husband of Nina W. Enersen, hereinafter referred to as "petitioner's wife."

(2) Petitioner and petitioner's wife are both individuals with residence at 2642 Baker Street,

San Francisco, California. The Federal income tax returns of petitioner and petitioner's wife for the calendar years 1944 and 1945 were filed with the Collector of Internal Revenue for the First District of California.

(3) The notices of deficiency, copies of which are attached to each of the petitions herein as Exhibit A, were mailed to the petitioner and petitioner's wife on October 26, 1948.

(4) The taxes in controversy herein are income taxes for the years 1944 and 1945 and are in the amounts of \$237.38 for 1944 and \$1,150.00 for 1945 in the case of petitioner, and in the amounts of \$257.38 for 1944 and \$983.37 for 1945 in the case of petitioner's wife.

(5) For approximately thirteen years prior to August 1, 1943, the petitioner had been employed by the law partnership of McCutchen, Thomas, Matthew, Griffiths & Greene, as a lawyer.

(6) Prior to January 1, 1940, the petitioner was paid a monthly salary plus an annual Christmas bonus amounting to a part of a month's salary by said partnership.

(7) From January 1, 1940, to August 1, 1943, the amount of petitioner's compensation from said partnership was fixed in accordance with certain agreements, each covering a calendar year or portion thereof. Copies of such agreements are attached hereto as Exhibits 1-A, 2-B, 3-C and 4-D. During each such calendar year (or fraction

thereof) the percentage of net profits fixed by the applicable agreement exceeded the minimum salary guaranteed by such agreement so that petitioner received as his entire compensation for the calendar year 1940 the percentage of the profits of said partnership specified in Exhibit 1-A, for the calendar year 1941 the percentage of the profits specified in Exhibit 2-B, for the calendar year 1942 the percentage of the profits specified in Exhibit 3-C, and for the fractional calendar year from January 1, to August 1, 1943, the percentage of profits specified in Exhibit 4-D. The guaranteed amount specified in each such agreement was paid monthly and the balance of petitioner's compensation for each year was paid at the end of the year.

(8) The petitioner became a partner in said partnership on August 1, 1943, and since that date has at all times here material been a partner in said firm.

(9) From and after August 1, 1943, petitioner as a partner in said partnership has at all times here material received a specified percentage of the net profits of said partnership, which increased from 3.25% on August 1, 1943, to 5.4571% on December 31, 1945, such amounts being paid in part monthly and the balance at the end of the year.

(10) Petitioner and petitioner's wife and said partnership have at all times here material followed the cash receipts and disbursements method of accounting in their tax returns and in any and all



books of account kept by petitioner or by petitioner's wife or by said partnership. Petitioner, petitioner's wife and said partnership have at all times here material made their tax returns on a calendar year basis.

(11) During the calendar years 1944 and 1945, said partnership received several amounts from clients for personal services on separate legal matters, such services being performed in each case over periods of several years. In seven cases in 1944 and ten cases in 1945 at least 80 per cent of the total compensation for personal services covering a period of thirty-six months or more (from the beginning to the completion of such services) was received by the partnership in a single taxable year. In the case of the largest such amount received in 1945, petitioner himself during the period from September, 1943, to December, 1945, was one of the attorneys performing the services for which such amount was paid as compensation; and in the case of one of the largest such amounts received in 1944, petitioner during the period from January, 1940, to January, 1944, was one of the attorneys performing the services for which such amount was paid as compensation.

(12) In so far as it has been legal to do so (i.e., with the exception of certain executors' fees forbidden by law to be shared with attorneys who are not executors and other compensations which could not be shared for similar reasons, none of which fees are involved in this case) all fees and



payments of compensation by other parties received by any member of said partnership in any calendar month have been pooled in a single fund which has been first used to pay all expenses of such month, and the balance then or at the end of the year was divided among all of the partners and all of those employees who were employed on a profit-sharing or percentage-of-profits basis. Each such division has been in accordance with the percentage shares agreed upon by the partners and in effect during the month in which the said fees have been received. Each partner and profit-sharing employee has shared in such division of all net fees and profits received during any period in which he has been entitled to a share in the partnership profits according to such agreement of the partners; conversely, when a partner or employee has ceased to be such by death or retirement or otherwise, he has not shared in any fee or fees received after the month in which the cessation has occurred.

(13) The procedure for division of fees and profits outlined in paragraph (12) has been followed by said partnership for many years and at all times herein mentioned.

(14) Pursuant to said procedure described in paragraph (12) above, each of the fees described in paragraph (11) above was divided according to their respective percentages at the time of its receipt among all partners and employees then entitled to share in profits.

(15) From such division of those certain fees

described in paragraph (11) above (i.e., only those fees for personal services performed over periods of thirty-six months or more which were received to the extent of 80 per cent or more in a single taxable year) the petitioner received \$3,561.13 in 1944 and \$10,791.68 in 1945.

(16) Petitioner and petitioner's wife were married in 1935. Petitioner and his wife resided together in California at all times thereafter which are here material, including all of 1944 and 1945. Said amounts received by petitioner as stated in paragraph (15) above constituted community property acquired subsequent to 1927.

(17)(a) In his returns for 1944 and 1945 the petitioner computed his income taxes attributable to the fees described in paragraph (11) above by first taking his partnership share of each of such fees received in such taxable year (1944 or 1945, as the case might be), aggregating in each case the amount for such year alleged in paragraph (15) above, and by then allocating each such share of each such fee ratably over that part of the period of performance by said partnership of the services for which such fee was received which preceded the date of receipt of such fee. Petitioner next treated as his income his community property half of each total amount so allocated to each of the years 1935 to 1945, inclusive, and all of each total amount so allocated to each of the years 1931 to 1934, inclusive, in each such case treating it as income for the year to which so allocated. Petition-

er's wife treated as her income her community property half of each total amount so allocated to each of the years 1935 to 1945, inclusive, in each such case treating it as income for the year to which so allocated.

(b) Under the procedure followed by petitioner in said returns, as outlined in subparagraph (a) above, the portions of said partnership fees received in 1944 or 1945 (as the case might be) which were allocated by petitioner to the different taxable years were as set forth in the following table:

	From Fees Rec'd in 1944	From Fees Rec'd in 1945
1945 .....	\$ .....	\$ 849.78
1944 .....	141.98	1,508.42
1943 .....	403.26	1,508.41
1942 .....	403.25	699.16
1941 .....	391.42	59.36
1940 .....	346.45	76.62
1939 .....	94.20	82.50
1938 .....	.....	78.91
1937 .....	.....	78.91
1936 .....	.....	78.91
1935 .....	.....	78.92
1934 .....	.....	157.83
1933 .....	.....	157.83
1932 .....	.....	157.83
1931 .....	.....	118.37
	<hr/>	<hr/>
	\$1,780.56	\$5,691.76

The portions of said partnership fees received in 1944 or 1945 (as the case might be) which were allocated by petitioner's wife to the different taxable years were as set forth in the following table:

	From Fees Rec'd in 1944	From Fees Rec'd in 1945
1945 .....	\$ .....	\$ 849.78
1944 .....	141.98	1,508.42
1943 .....	403.26	1,508.41
1942 .....	403.25	699.16
1941 .....	391.42	59.36
1940 .....	346.45	76.62
1939 .....	94.20	82.50
1938 .....	.....	78.91
1937 .....	.....	78.92
1936 .....	.....	78.92
1935 .....	.....	78.92
	<hr/>	<hr/>
	\$1,780.56	\$5,099.92

(c) Petitioner in said returns then determined the taxes which would have been attributable to the respective amounts in each column of the table in subparagraph (b) above, if such amounts had been received by him as income in the respective years to which allocated in such column of such table in subparagraph (b) above, and substituted the aggregate of the taxes so attributable to the amounts in each such column for the tax which would otherwise have been payable on account of receipt of the total of such amounts during the taxable year of receipt (1944 or 1945, as the case



might be). Petitioner's Federal income tax returns for 1944 and 1945 referred to in paragraph (2) above, computed his taxes for said years on the basis of making such substitution. The same procedure was followed by petitioner's wife in her returns.

Dated: November 7, 1949.

/s/ HENRY S. COSTIGAN,

/s/ GORDON M. WEBER,  
Counsel for Petitioner.

/s/ CHARLES OLIPHANT, ECC  
Chief Counsel, Bureau of Internal Revenue, Coun-  
sel for Respondent.

Filed T.C.U.S. November 7, 1949.

---

The Tax Court of the United States  
Docket No. 20978 and Docket No. 20979

BURNHAM ENERSEN, NINA W. ENERSEN,  
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

Monday, November 7, 1949

Met, pursuant to notice, at 2:20 o'clock p.m.  
Before: Hon. Marion J. Harron,  
Judge.

Appearances:

HENRY D. COSTIGAN, and

GORDON WEBER,

Appearing on behalf of the Petitioners.

EARL C. CROUTER,

(Hon. Charles Oliphant, Chief Counsel,  
Bureau of Internal Revenue),

Appearing for the Respondent.

### PROCEEDINGS

The Clerk: I will call Docket No. 20978 and 20979, Burnham Enersen and Nina W. Enersen. Please state your appearances, gentlemen.

Mr. Costigan: Henry D. Costigan and Gordon Weber, appearing for Petitioners in both cases.

Mr. Crouter: And Earl C. Crouter for the Respondent in each case.

Mr. Costigan: If the Court please, the stipulation of facts which we will expect to file and can file now provides in Paragraph 1 that both of these cases involve the same years and identical facts and may be consolidated for purposes of hearing and of opinion. We should like to move now that that be done.

The Court: The motion is granted.

### OPENING STATEMENT ON BEHALF OF PETITIONERS

By Mr. Costigan:

The wife's case, Mrs. Enersen's, is simply the

same as that of the Petitioner, because of the community property law, as in the Nielson cases this morning, your Honor. The facts are somewhat different from that case but primarily there is the same question of law involved; namely, the application of Section 107 to a partner's share of partnership earnings received after he became a partner but earned in part by services before he became a partner. The facts have some important differences, I think, and I would like to briefly mention what they are.

With respect to the Petitioner's—and I refer to the husband when I refer to Petitioner's—status, in this case he was employed by the partnership involved beginning in 1930. For a period of 10 years he was simply on a salary as an employee. Beginning January 1st, 1940, he was still an employee but he was compensated by a percentage of profits with a guaranteed minimum monthly account or salary, which he was to get in any event, but in every year following his percentage exceeded the minimum amount so that, in effect, his entire compensation was a percentage of profits.

Then on August 1, 1943, he was made a partner with an increased percentage in the profits. The fees involved and the tax years involved are 1944 and 1945 and there was, I think, seven fees received in the first of those years and ten in the second, or I may have that reversed but it is one way or the other. Each of those fees represented compensation for services performed by the partner-

ship over a period of more than 36 months, as required by Section 107, and in each case more than 80 per cent, or 80 per cent or more, was received in the one year 1944 or 1945, as the case might be. Mr. Enersen's share of those fees in that classification in 1944 was \$3,561.13. That is stipulated, and in 1945 it was \$10,791.68.

As your Honor can see, the services, the 36 months' period preceding receipt of each fee, did extend back beyond his entry into the partnership. However, it did not extend back beyond the period when he was first compensated with a share of profits, because that began in 1940, which was more than three years prior to the first taxable year here involved. Of course, in some cases the services were performed even in years prior to that.

It is our position that Section 107 applies directly to any cases where the partnership itself performed services over 36 months or more and received 80 per cent in a single year, but if that situation exists, then by its very terms, and I quote from the section, "The tax attributable to any part thereof which is included in the gross income of any individual" shall not be greater than it would have been, in effect, if it had been allocated back over the period of services.

As a result of this, both Mr. Enersen as to his community half and Mrs. Enersen as to hers allocated the fees back over the years involved. In the case of the 1944 fees they went back to 1939. In the case of the 1945 fees they went back to 1931. All



the facts on the subject are, we believe, covered by the stipulation.

I should therefore like to offer that for the record and call the Court's attention to the fact that there are four exhibits attached and incorporated by reference. They are joint exhibits so we have called them Exhibits 1-A, 2-B, 3-C, and 4-D.

The Court: The stipulation is received and made a part of the record and the exhibits attached to the stipulation are admitted in evidence.

(Whereupon the documents were marked for identification as Joint Exhibits 1-A, 2-B, 3-C, and 4-D and were received in evidence.)

### JOINT EXHIBIT 1-A

#### Memorandum by Participant—1940

In order to link them still more closely with the business of the firm, and to give them a direct financial interest in its welfare, recognition is accorded to certain members of our staff of attorneys, in addition to Monthly Guaranties, in certain Participating Percentages, contingent, in each case, on their remaining members of the staff throughout the calendar year. The Monthly Guaranties are to be paid in lieu of salaries. The Participating Percentages will not be computed or paid until after the close of the calendar year. The total paid during the year by way of Monthly Guaranty is to be credited on the Participating Percentage, and settlement will be made for the balance.

The Participating Percentages are to be com-

puted on the year's "Net Fees Before Participation." In arriving at that figure all expenses for the year are to be deducted except Monthly Guaranties paid participants and except salaries paid to partners.

In order to safeguard the provision thus made for participants, it must be stipulated that the participating privilege does not constitute participants' partners, or amount to a contract of employment on an annual or other basis or restrict the partners' freedom of action in terminating any employment at any time; that it gives the participants no voice in firm decisions or right of access to books or right to receive detailed statements, and in any question of amounts or of computations the decisions of Price, Waterhouse & Co., or other certified accountants employed by the firm is to be final. Percentages are based on present conditions and it is contemplated that percentages may be changed at any time on notice to the participants affected and that other persons may be admitted to participation at any time as the partners may consider appropriate.

This memorandum is to receive the approval of the participant mentioned below and will be handed the Accounting Department for its guidance. The percentages paid participants are paid them by way of compensation only and not as parties to a joint business venture. The Accounting Department shall treat them accordingly for income tax and all other purposes. The participants should return the amounts received in their income tax returns as "Salaries, wages, etc." and not as "Income from a

partnership.” The amount is to be allocated to the year in respect of which paid, even though not actually paid until the following year after the books for the year in question shall have been closed.

Mr. Burnham Enersen, having been selected as a participant, his Monthly Guaranty is fixed at \$400.00 beginning January 1, 1940, and his Participating Percentage is fixed at 1.5 per cent, beginning with the calendar year 1940. This memorandum shall operate to supersede and cancel any prior memorandum, such supersession and cancellation to be effective as at the date hereof, subject to rights under any such prior memorandum heretofore accrued in respect to the year 1939.

Approved as of January 1, 1940.

/s/ BURNHAM ENERSEN.

Admitted November 7, 1949.

---

## JOINT EXHIBIT 2-B

### Memorandum by Participant—1941

In order to link them still more closely with the business of the firm, and to give them a direct financial interest in its welfare, recognition is accorded to certain members of our staff of attorneys, in addition to Monthly Guaranties, in certain Participating Percentages, contingent, in each case, on their remaining members of the staff throughout the calendar year. The Monthly Guaranties are to be paid in lieu of salaries. The Participating Percentages will not be computed or paid until after the close of



the calendar year. The total paid during the year by way of Monthly Guaranty is to be credited on the Participating Percentage, and settlement will be made for the balance.

The Participating Percentages are to be computed on the year's "Net Fees Before Participation." In arriving at that figure all expenses for the year are to be deducted except Monthly Guaranties paid participants and except salaries paid to partners.

In order to safeguard the provision thus made for participants, it must be stipulated that the participating privilege does not constitute participants' partners, or amount to a contract of employment on an annual or other basis or restrict the partners' freedom of action in terminating any employment at any time; that it gives the participants no voice in firm decisions or right of access to books or right to receive detailed statements, and in any question of amounts or of computations the decision of Price, Waterhouse & Co., or other certified accountants employed by the firm is to be final. Percentages are based on present conditions and it is contemplated that percentages may be changed at any time on notice to the participants affected and that other persons may be admitted to participation at any time as the partners may consider appropriate.

This memorandum is to receive the approval of the participant mentioned below and will be handed the Accounting Department for its guidance. The percentages paid participants are paid them by way of compensation only and not as parties to a joint



business venture. The Accounting Department shall treat them accordingly for income tax and all other purposes. The participants should return the amounts received in their income tax returns as "Salaries, wages, etc." and not as "Income from a partnership." The amount is to be allocated to the year in respect of which paid, even though not actually paid until the following year after the books for the year in question shall have been closed.

Mr. Enersen, having been selected as a participant, his Monthly Guaranty is fixed at \$400 beginning January 1, 1941, and his Participating Percentage is fixed at 1.75 per cent, beginning with the calendar year 1941. This memorandum shall operate to supersede and cancel any prior memorandum, such supersession and cancellation to be effective as at the date hereof, subject to rights under any such prior memorandum heretofore accrued in respect to the year 1940.

Approved as of January 1, 1941.

/s/ BURNHAM ENERSEN.

Admitted November 7, 1949.

---

### JOINT EXHIBIT 3-C

#### Memorandum by Participant—1942

In order to link them still more closely with the business of the firm, and to give them a direct financial interest in its welfare, recognition is accorded to certain members of our staff of attorneys,

in addition to Monthly Guaranties, in certain Participating Percentages, contingent, in each case, on their remaining members of the staff throughout the calendar year. The Monthly Guaranties are to be paid in lieu of salaries. The Participating Percentages will not be computed or paid until after the close of the calendar year. The total paid during the year by way of Monthly Guaranty is to be credited on the Participating Percentage, and settlement will be made for the balance.

Participating Percentages are to be computed on the year's "Net Fees Before Participation." In arriving at that figure there shall be deducted all expenses for the year, including depreciation as regularly charged and including the amount, if any, by which the Monthly Guaranty paid any Participant or Participants shall exceed the amount paid or payable to such Participant or Participants as Participating Percentage. However, salaries, if any, paid to partners shall not be deducted.

In order to safeguard the provision thus made for participants, it must be stipulated that the participating privilege does not constitute participants' partners, or amount to a contract of employment on an annual or other basis or restrict the partners' freedom of action in terminating any employment at any time; that it gives the participants no voice in firm decisions or right of access to books or right to receive detailed statements, and in any question of amounts or of computations the decision of Price, Waterhouse & Co., or other certified

accountants employed by the firm is to be final. Percentages are based on present conditions and it is contemplated that percentages may be changed at any time on notice to the participants affected and that other persons may be admitted to participation at any time as the partners may consider appropriate.

This memorandum is to receive the approval of the participant mentioned below and will be handed the Accounting Department for its guidance. The percentages paid participants are paid them by way of compensation only and not as parties to a joint business venture. The Accounting Department shall treat them accordingly for income tax and all other purposes. The participants should return the amounts received in their income tax returns as "Salaries, wages, etc." and not as "Income From a Partnership." The amount is to be allocated to the year in respect of which paid, even though not actually paid until the following year after the books for the year in question shall have been closed.

Mr. Burnham Enersen, having been selected as a participant, his Monthly Guaranty is fixed at \$400.00 beginning January 1, 1942, and his Participating Percentage is fixed at 2.25 per cent, beginning with the calendar year 1942. This memorandum shall operate to supersede and cancel any prior memorandum, such supersession and cancellation to be effective as at the date hereof, subject to rights under



any such prior memorandum heretofore accrued in respect to the year 1941.

Approved as of January 1, 1942.

/s/ BURNHAM ENERSEN.

Admitted November 7, 1949.

---

### JOINT EXHIBIT 4-D

#### Memorandum by Participant—1943

In order to link them still more closely with the business of the firm, and to give them a direct financial interest in its welfare, recognition is accorded to certain members of our staff of attorneys, in addition to Monthly Guaranties, in certain Participating Percentages, contingent, in each case, on their remaining members of the staff throughout the calendar year. The Monthly Guaranties are to be paid in lieu of salaries. The Participating Percentages will not be computed or paid until after the close of the calendar year. The total paid during the year by way of Monthly Guaranty is to be credited on the Participating Percentage, and settlement will be made for the balance.

Participating Percentages are to be computed on the year's "Net Fees Before Participation." In arriving at that figure there shall be deducted all expenses for the year, including depreciation as regularly charged and including the amount, if any, by which the Monthly Guaranty paid any Participant or Participants shall exceed the amount paid



or payable to such Participant or Participants as Participating Percentage. However, salaries, if any, paid to partners shall not be deducted.

In order to safeguard the provision thus made for participants, it must be stipulated that the participating privilege does not constitute participants' partners, or amount to a contract of employment on an annual or other basis or restrict the partners' freedom of action in terminating any employment at any time; that it gives the participants no voice in firm decisions or right of access to books or right to receive detailed statements, and in any question of amounts or of computations the decision of Price, Waterhouse & Co., or other certified accountants employed by the firm is to be final. Percentages are based on present conditions and it is contemplated that percentages may be changed at any time on notice to the participants affected and that other persons may be admitted to participation at any time as the partners may consider appropriate.

This memorandum is to receive the approval of the participant mentioned below and will be handed the Accounting Department for its guidance. The percentages paid participants are paid them by way of compensation only and not as parties to a joint business venture. The Accounting Department shall treat them accordingly for income tax and all other purposes. The participants should return the amounts received in their income tax returns as "Salaries, wages, etc.," and not as "Income From a Partnership." The amount is to be allocated to the year in respect of which paid, even though not

actually paid until the following year after the books for the year in question shall have been closed.

Mr. Burnham Enersen, having been selected as a participant, his Monthly Guaranty is fixed at \$500.00 beginning January 1, 1943, and his Participating Percentage is fixed at 2.65 per cent, beginning with the calendar year 1943. This memorandum shall operate to supersede and cancel any prior memorandum, such supersession and cancellation to be effective as at the date hereof, subject to rights under any such prior memorandum heretofore accrued in respect to the year 1942.

Approved as of January 1, 1943.

/s/ BURNHAM ENERSEN.

Admitted November 7, 1949.

---

Mr. Costigan: I think that that completes our case.

#### OPENING STATEMENT ON BEHALF OF RESPONDENT

By Mr. Crouter:

If your Honor please, I will be very brief on this. These proceedings as I view them are quite similar to the Nielson cases, which were submitted to the Court this morning, and involve a similar question. The facts are quite similar and in some respects more complete in this case, because there were written agreements relating to the employment of the Petitioner, Mr. Enersen here, in this period prior

to the time when he became a partner, and those set forth the exact compensation arrangement both as salary and with respect to participation in profits and very clearly and definitely provide that this shall not be considered as any distribution of partnership earnings, so the question will be similar to those other cases. The Commissioner's position is very similar, as in the other cases, and arises upon a similar determination by the Commissioner that Section 107 does not apply, the statement attached to the Deficiency Notice reading in part as follows: "It is held that prior to August 1, 1943, you were an employee of the partnership and did not have the right to participate in fees earned by the partnership prior to that date."

Counsel refers to some portion of the statute, being Section 107, but as the Court well knows that statute starts out and reads: "If at least 80 per centum of the total compensation for personal services covered a period 36 calendar months or more," and so forth.

Now, Respondent's position is that under these facts, and we try to include all of the facts, so that may be a little immaterial but to get the whole picture in there, the facts will show the Court that the Petitioner, Mr. Enersen, was fully compensated under his arrangement and under the contracts down to this period of August 1, 1943, when he became a partner and when he, of course, received a greater percentage than a mere employee.

Now, our taxable years, of course, are calendar years 1944 and 1945. Therefore, he did not have a

full three years' status. I will not try to discuss the facts further, because I think that is more in the nature of argument.

I would like to submit a complete photostat of the tax returns involved as the next exhibit, starting with "E," if that is agreeable at this time.

Mr. Costigan: No objection.

Mr. Crouter: 1944 income tax return of Burnham Enersen as Exhibit E.

The Court: It is received in evidence, Exhibit E.

(Whereupon the document was marked for identification as Exhibit E and was received in evidence.)



# RESPONDENT'S EXHIBIT E

File this return with Collector of Internal Revenue on or before March 15, 1945. Any balance of tax due (Item 8, below) must be paid in full with return. See separate instructions for filling out return.

## U. S. INDIVIDUAL INCOME TAX RETURN FOR CALENDAR YEAR 1944

1944

FORM 1040  
Treasury Department  
Internal Revenue Service

or fiscal year beginning 1944, and ending 1945

Do not write in these spaces

— CREDIT

470143

EMPLOYEES.—Instead of this form, you may use your Withholding Receipt, Form W-2 (Rev.), as your return, if your total income was less than \$5,000, consisting wholly of wages shown on Withholding Receipts or of such wages and not more than \$100 of other wages, dividends, and interest.

NAME BURNHAM ENERSEN  
(PLEASE PRINT. If this return is for a husband and wife, use both first names)

ADDRESS 2172 Green Street  
(PLEASE PRINT. Street and number or rural route)

San Francisco 23, Calif. Social Security No. (if any) 545-09-5716

File Code

District

(Check one)

7714308

94

MAR 13 1945

COLL. INT. RE. 1st DIST. CAL.

1. List your own name. If married and your wife (or husband) had no income, or if this is a joint return of husband and wife, list name of your wife (or husband). List names of other close relatives with 1944 incomes of less than \$500. If this is a joint return of husband and wife, list dependent relatives of both.

NAME (Please print)	Relationship
Your name <u>Burnham Enersen</u>	XXXXXX
<u>Richard W. Enersen</u>	Son

2. Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1944, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Members of armed forces and persons claiming traveling or reimbursed expenses, see Instruction 2.

PRINT EMPLOYER'S NAME	WHERE EMPLOYED (CITY AND STATE)	AMOUNT
		\$

3. Enter here the total amount of your dividends and interest (including interest from Government obligations unless wholly exempt from taxation) Enter total here → \$ 90.38

4. If you received any other income, give details on page 3 and enter the total here 6148.83

5. Add amounts in items 2, 3, and 4, and enter the total here \$ 6239.21

If item 5 includes income of both husband and wife, show husband's income here, \$; wife's income here, \$.

IF YOUR INCOME WAS LESS THAN \$5,000.—You may find your tax in the tax table on page 2. This table, which is provided by law, is based on the same tax rates as are used in the Tax Computation on page 4. The table automatically allows about 10 percent of your total income for charitable contributions, interest, taxes, casualty losses, medical expenses, and miscellaneous expenses. If your expenditures and losses of those classes amount to more than 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 4.

IF YOUR INCOME WAS \$5,000 OR MORE.—Disregard the tax table and compute your tax on page 4. You may either take a standard deduction of \$500 or itemize your deductions, whichever is to your advantage.

HUSBAND AND WIFE.—If husband and wife file separate returns, and one itemizes deductions, the other must also itemize deductions.

6. Enter your tax from table on page 2, or from line 15, page 4 \$ 951.99

7. How much have you paid on your 1944 income tax?

(A) By withholding from your wages (Attach Withholding Receipts, Form W-2) \$ 150.96

(B) By payments on 1944 Declaration of Estimated Tax 850.00

Enter total here → 1000.96

8. If your tax (item 6) is larger than payments (item 7), enter BALANCE OF TAX DUE here \$ 48.97

9. If your payments (item 7) are larger than your tax (item 6), enter the OVERPAYMENT here \$ 48.97

Check (✓) whether you want this overpayment: Refunded to you ☐; or Credited on your 1945 estimated tax ☒

If you filed a return for a prior year, what was the latest year? 1943

To which Collector's office as it sent? San Francisco

To which Collector's office did you pay amount claimed in item 7 (B), above? San Francisco

Is your wife (or husband) making a separate return for 1944? Yes

If "Yes," write below:

Name of wife (or husband) Nida W. Enersen

Collector's office to which sent San Francisco

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person (other than taxpayer or agent) preparing return)

(Date)

(Signature of taxpayer)

(Date)

(Name of firm or employer, if any)

(If this is a joint return of husband and wife, it must be signed by both)

(SEE TAX TABLE BELOW)

16-41080-1

46



Do not use this page if your income is wholly from salaries, wages, dividends, and interest

Schedule A.—INCOME FROM ANNUITIES OR PENSIONS

1. Cost of annuity (total amount you paid in)	\$	4. Total amount received this year	\$
2. Amount received tax-free in prior years		5. Excess, if any, of line 4 over line 3	
3. Remainder of your cost (line 1 less line 2)	\$	6. Enter line 5, or 3 percent of line 1, whichever is greater	\$

Schedule B.—INCOME FROM RENTS AND ROYALTIES

1. Kind of property	2. Amount of rent or royalty	3. Depreciation or depletion (explain in Schedule F)	4. Repairs (explain in Schedule G)	5. Other expenses (explain in Schedule G)
	\$	\$	\$	\$
Net profit (or loss) (col. 2 less sum of cols. 3, 4, and 5)	\$	\$	\$	\$

Schedule C.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION. (Farmers should obtain Form 1040F)

(State (1) nature of business \_\_\_\_\_; (2) business name \_\_\_\_\_)

1. Total receipts	\$	OTHER BUSINESS DEDUCTIONS	
COST OF GOODS SOLD (To be used where inventories are an income-determining factor) (Enter the letters "C," "M," or "I" on line 2 and 3 if inventories are valued at either cost, or cost or market whichever is lower)		11. Salaries and wages not included as "Labor"	\$
2. Inventory at beginning of year	\$	12. Interest on business indebtedness	
3. Merchandise bought for sale		13. Taxes on business and business property	
4. Labor		14. Losses (explain in Schedule G)	
5. Material and supplies		15. Bad debts arising from sales or services	
6. Other costs (explain in Schedule G)		16. Depreciation, obsolescence and depletion (explain in Schedule F)	
7. Total of lines 2 to 6	\$	17. Rent, repairs, and other expenses (explain in Schedule G)	
8. Less inventory at end of year		18. Amortization of emergency facilities (attach statement)	
9. Net cost of goods sold (line 7 less line 8)	\$	19. Net operating loss deduction (attach statement)	
10. Gross profit (line 1 less line 9)	\$	20. Total of lines 11 to 19	\$
		21. Total of lines 9 and 20	\$
		22. Net profit (or loss) (line 1 less line 21)	

Schedule D.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.

1. Net gain (or loss) from sale or exchange of capital assets (from separate Schedule D) \_\_\_\_\_

2. Net gain (or loss) from sale or exchange of property other than capital assets (from separate Schedule D) \_\_\_\_\_

Schedule E.—INCOME FROM PARTNERSHIPS, ESTATES AND TRUSTS, AND OTHER SOURCES

Name and address of partnership, syndicate, etc. **McCutchen, Thomas, Matthew** Amount, \$ **6148.83**

Name and address of estate or trust **Griffiths & Greene** Amount, \_\_\_\_\_

Other sources (state nature) \_\_\_\_\_ Amount, \_\_\_\_\_

Total **6148.83**

Total income from above sources (Enter as item 4, page 1) \$ **6148.83**

Schedule F.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES B AND C

1. Kind of property (If buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (Do not include land or other nondepreciable property)	4. Assets fully depreciated in use at end of year	5. Depreciation allowed (or allowable) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in accumulating depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
		\$	\$	\$	\$			\$

Schedule G.—EXPLANATION OF COLUMNS 4 AND 5 OF SCHEDULE B, AND LINES 6, 14, AND 17 OF SCHEDULE C

1. Column or Line No.	2. Explanation	3. Amount	1. Column or Line No.	2. Explanation	3. Amount
		\$			\$





Do not itemize deductions if—(1) You determine your tax from the tax table on page 2, or  
(2) Your total income is \$5,000 or more and you claim the \$500 standard deduction.  
If husband and wife living together at end of year file separate returns and one itemizes deductions, the other must file his or her return on Form 1040, and must also itemize deductions.

### DEDUCTIONS

Describe deductions and state to whom paid. If more space is needed, list deductions on separate sheet of paper and attach to this return

Amount

#### Contributions

Allowable Contributions (not in excess of 15 percent of item 5, page 1)

#### Interest

Total Interest

#### Taxes

Total Taxes

Losses from fire, storm, shipwreck, or other casualty, or theft

Total Allowable Losses (not compensated by insurance or otherwise)

#### Medical and dental expenses

Net Expenses (not compensated by insurance or otherwise)

Enter 5 percent of item 5, page 1, and subtract from Net Expenses

Allowable Medical and Dental Expenses. See Instruction for limitation

Miscellaneous (including alimony, amortizable bond premium, special deduction for the blind, etc.)

Total Miscellaneous Deductions

TOTAL DEDUCTIONS

### TAX COMPUTATION—FOR PERSONS NOT USING TAX TABLE ON PAGE 2

1. Enter amount shown in item 5, page 1. This is your Adjusted Gross Income.	6239.21
2. Enter DEDUCTIONS (if deductions are itemized above, enter the total of such deductions; if adjusted gross income (line 1, above) is \$5,000 or more and deductions are not itemized, enter the standard deduction of \$500).	500.00
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income.	5739.21
4. Enter your Surtax Exemptions (\$500 for each person listed in item 1, page 1).	1000.00
5. Subtract line 4 from line 3. Enter the difference here. This is your Surtax Net Income.	4739.21
6. Use the Surtax Table in instruction sheet to figure your Surtax on amount entered on line 5. Enter the amount here.	1032.19
7. Copy the figure you entered on line 3, above. (If line 3 includes partially tax-exempt interest, see Tax Computation Instructions).	5739.21
8. Enter your Normal-Tax Exemption (\$500 if return includes income of only one person; otherwise see Tax Computation Instructions).	500.00
9. Subtract line 8 from line 7, and enter the difference here.	5239.21
10. Enter here 3 percent of line 9. This is your Normal Tax.	157.18
11. Add the figures on lines 6 and 10, and enter the total here. (If alternative tax computation is made on separate Schedule D, enter here tax from line 15 of Schedule D).	1189.37
If you used the \$500 standard deduction in line 2, disregard lines 12, 13, & 14, and copy on line 15 the same figure you entered on line 11	
12. Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116)	
13. Enter here any income tax paid at source on tax-free covenant bond interest.	
14. Add the figures on lines 12 and 13 and enter the total here. Reduction under Section 107	237.38
15. Subtract line 14 from line 11. Enter the difference here and in item 6, page 1. This is your tax.	951.99



Form 872

Duplicate

Consent Fixing Period of Limitation Upon  
Assessment of Income and Profits Tax

Dec. 30, 1947.

In pursuance of the provisions of existing Internal Revenue Laws, Burnham Enersen, a taxpayer (or taxpayers) of 2172 Green Street, San Francisco, California, and the Commissioner of Internal Revenue hereby consent and agree as follows:

That the amount of any income, excess-profits, or war-profits taxes due under any return (or returns) made by or on behalf of the above-named taxpayer (or taxpayers) for the taxable year ended December 31, 1944, under existing acts, or under prior revenue acts, may be assessed at any time on or before June 30, 1949, except that, if a notice of a deficiency in

tax is sent to said taxpayer (or taxpayers) by registered mail on or before said date, then the time for making any assessment as aforesaid shall be extended beyond the said date by the number of days during which the Commissioner is prohibited from making an assessment and for sixty days thereafter.

/s/ BURNHAM ENERSEN,  
Taxpayer.<sup>1</sup>

[Seal<sup>2</sup>]: /s/ GEO. J. SCHOENEMAN,  
Commissioner of  
Internal Revenue.

By /s/ R. L. S.

Date: 12/31/47.

---

<sup>1</sup>This consent may be executed by the taxpayer's attorney or agent, provided such action is specifically authorized by a power of attorney, which, if not previously filed, must accompany the consent.

If executed with respect to a year for which a Joint Return of a Husband and Wife was filed, this consent must be signed by both spouses unless one spouse, acting under a power of attorney, signs as agent for the other.

---

<sup>2</sup>If this consent is executed on behalf of a corporation, it shall be signed with the corporate name, followed by the signature and title of such officer or officers of the corporation as are empowered under the laws of the State in which the corporation is located to sign for the corporation, in addition to which the seal of the corporation must be affixed. Where the corporation has no seal, the consent must be accompanied by a certified copy of the resolution passed by the board of directors, giving the officer authority to sign the consent.



Schedule Attached to  
United States Individual Income Tax Return  
1944

Burnham Enersen

Note: The income reported hereon is one-half of the community income of taxpayer and wife, and all deductions shown are one-half of their total deductions. The other one-half of such income and deductions is reported on the return of taxpayer's wife, Nina W. Enersen.

Computation of Reduction in Tax under Section 107 of I.R.C.

Tax on entire income at 1944 rates (page 4, Item 11) .....	\$1,189.37
Adjusted Gross Income (page 4, Item 1) .....	\$6,239.21
Less share of partnership fees allocable to prior years .....	1,638.58
Balance taxable at 1944 rates .....	<u>\$4,600.63</u>
Tax thereon—see table .....	<u>766.00</u>
Portion of tax attributable to income allocated to prior years .....	\$ 423.37

Tax on income allocated to prior years:

Taxable Year	Income Allocated	Tax	
1943.....	\$ 403.26	\$ 97.99	
1942.....	403.25	21.57	
1941.....	391.42	49.32	
1940.....	346.45	13.72	
1939.....	94.20	3.39	
	<u>\$1,638.58</u>	<u>\$185.99</u>	185.99

Reduction in tax by use of Section 107 (page 4, Item 14) .....	<u><u>\$ 237.38</u></u>
--	-------------------------

## POWER OF ATTORNEY

Know All Men by These Presents:

That the undersigned, Burnham Enersen, does hereby make, constitute and appoint Henry D. Costigan, Stanley Morrison and Gordon M. Weber, the address of all of whom is 351 California Street, San Francisco, California, jointly, and each of them severally, his true and lawful attorney and attorneys, for him and in his name, place and stead, to prepare, execute and file returns and amended returns for the undersigned for the calendar years 1944 and 1945 under the Revenue Acts of the United States of America; to appear before the Treasury Department of the United States and the Bureau of Internal Revenue and other bureaus, agencies, officers and agents of said Department, before the United States Tax Court, before any board or commission, and before any court or courts of any state or of the United States, and to represent the undersigned in all matters arising out of or in any respect connected with any or all returns or amended returns heretofore or hereafter filed by him, or relating to the determination of such taxes, if any, as may be found to be due from him under any Revenue Act or Acts of the United States of America for the said calendar years 1944 and 1945; to have access to and examine all documents and data in the possession of said Treasury Department, or any bureau, agency, officer or agent of said Department, or said Tax Court, or any board or commission, or any court, with respect to the liability

of the undersigned for federal taxes under any statute of the United States imposing such taxes, and to secure therefrom any and all information relative thereto; to receive but not to endorse and collect checks in settlement of any refund made to the undersigned; to delegate any or all of the authority herein granted; to substitute another agent or attorney, or other agents or attorneys; to execute for him and on his behalf, any waiver or waivers or consent or consents agreeing to a later determination and assessment of taxes than is provided by statutes of limitations, to execute for the undersigned and on his behalf, closing agreements relative to the tax liability of the undersigned; to sign for him and on his behalf, refund, credit or abatement claims, protests, letters, petitions on appeal, pleadings and any other papers or documents whatsoever in connection with said taxes; provided that the enumeration herein of specific powers shall not be construed as a limitation upon the authority of said attorneys and each of them to do any act which the undersigned might lawfully do.

Giving and Granting unto his said attorneys, and to each of them severally, full power and authority to do and perform every act and thing whatsoever necessary or convenient to be done in the premises as fully to all intents and purposes as the undersigned might do or could do, with full power of substitution or revocation, hereby ratifying and confirming all that his said attorneys, or any of them or their substitute or substitutes, or the substitute or substitutes of any of them, shall lawfully do or

cause to be done by virtue thereof.

And the undersigned does hereby revoke all powers of attorney heretofore given for the foregoing purposes.

In Witness Whereof, the undersigned has hereunto subscribed his name, this 14th day of May, 1948.

Executed in Triplicate.

/s/ BURNHAM ENERSEN.

State of California,

City and County of San Francisco—ss.

On this 14th day of May, 1948, before me, Chalmer Munday, a Notary Public in and for the City and County of San Francisco, State of California, residing therein, duly commissioned and sworn, personally appeared Burnham Enersen, known to me to be the person described in and whose name is subscribed to and who executed the within and foregoing instrument, and acknowledged to me that he executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal at my office in said City and County and State the day and year in this certificate first above written.

[Seal]      /s/ CHALMER MUNDAY,  
Notary Public in and for the City and County of  
San Francisco, State of California.

Admitted November 7, 1949.



Mr. Crouter: The 1945 return of Burnham Enersen as Exhibit F.

The Court: Received in evidence, Exhibit F.

(Whereupon the document was marked for identification as Exhibit F and was received in evidence.)



# RESPONDENT'S EXHIBIT F

55

File this return with Collector of Internal Revenue on or before March 15, 1946. Any balance of tax due (item 8, below) must be paid in full with return. See separate instructions for filling out return.

FORM 1040  
Treasury Department  
Internal Revenue Service

## U. S. INDIVIDUAL INCOME TAX RETURN FOR CALENDAR YEAR 1945

194

or fiscal year beginning \_\_\_\_\_, 1945, and ending \_\_\_\_\_, 1946

EMPLOYEES.—Instead of this form, you may use your Withholding Receipt, Form W-2, as your return, if your total income was less than \$5,000, consisting wholly of wages shown on Withholding Receipts or of such wages and not more than \$100 of other wages, dividends, and interest.

Do not write in these spaces

File Code 851  
Serial No. 3019  
District 1-Calif  
(Cashier's Stamp)

NAME BURNHAM ENERSEN  
(PLEASE PRINT. If this return is for a husband and wife, give both first names)

ADDRESS 2172 Green Street  
(PLEASE PRINT. Street and number or rural route)

San Francisco 23, California  
(City or town, postal zone number) (County)

Occupation Lawyer Social Security No. 545-09-5716

REC'D WITH REMITTANCE

**94** MAR 7 1946  
COLL. INT. RE.  
1st DIST. CAL.  
NO. 15

List your own name.  
If married and your wife (or husband) had no income, or if this is a joint return of husband and wife, list name of your wife (or husband).

List names of other close relatives (as defined in instruction 1) with 1945 incomes of less than \$500 who received more than one-half of their support from you. If this is a joint return of husband and wife, list dependent relatives of both.

Name (please print)	Relationship	Name (please print)	Relationship
Your name <u>Burnham Enersen</u>	<u>xxxxxx</u>		
<u>Richard W. Enersen</u>	<u>Son</u>		

DATE By L. T. Payne

Enter your total wages, salaries, bonuses, commissions, and other compensation received in 1945, BEFORE PAY-ROLL DEDUCTIONS for taxes, dues, insurance, bonds, etc. Members of armed forces and persons claiming travel or reimbursed expenses, see instruction 2.

2.	Print Employer's Name	Where Employed (City and State)	Amount
			\$

Enter total here → \$

3. Enter here the total amount of your dividends and interest (including interest from Government obligations unless wholly exempt from taxation) 92.

4. If you received any other income, give details on page 2 and enter the total here. 15,245.

5. Add amounts in items 2, 3, and 4, and enter the total here. 15,337.

If item 5 includes incomes of both husband and wife, show husband's income here, \$; wife's income here, \$.

IF YOUR INCOME WAS LESS THAN \$5,000.—You may find your tax in the tax table on page 4. This table, which is provided by law, automatically allows about 10 percent of your total income for charitable contributions, interest, taxes, casualty losses, medical expenses, and miscellaneous expenses. If your expenditures and losses of these classes amount to more than 10 percent, it will usually be to your advantage to itemize them and compute your tax on page 3.

IF YOUR INCOME WAS \$5,000 OR MORE.—Disregard the tax table compute your tax on page 3. You may either take a standard deduction of \$300 or itemize your deductions, whichever is to your advantage.

HUSBAND AND WIFE.—If husband and wife file separate returns, and itemize deductions, the other must also itemize deductions.

6. Enter your tax from table on page 4, or from line 15, page 3. 3,406.

7. How much have you paid on your 1945 income tax?

(A) By withholding from your wages 296.71

(B) By payments on 1945 Declaration of Estimated Tax 1800.00

Enter total here → 2,096.

8. If your tax (item 6) is larger than payments (item 7), enter BALANCE OF TAX DUE here 1,310.

9. If your payments (item 7) are larger than your tax (item 6), enter the OVERPAYMENT here.

Check (✓) whether you want this overpayment: Refunded to you ☐; or Credited on your 1946 estimated tax ☐

If you filed a return for a prior year, what was the latest year? 1944

To which Collector's office was it sent? San Francisco

To which Collector's office did you pay amount claimed in item 7 (B), above? San Francisco

Is your wife (or husband) making a separate return for 1945? Yes

If "Yes," write below:

Name of wife (or husband) Nina W. Enersen

Collector's office to which sent San Francisco

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

(Signature of person (other than taxpayer or agent) preparing return) (Date)

Burnham Enersen MAR - 6  
(Signature of taxpayer) (Date)

(Name of firm or employer, if any) (If this is a joint return of husband and wife, it must be signed by both)

16-5879





Do not use this page if your income is wholly from salaries, wages, dividends, and interest

**Schedule A.—INCOME FROM ANNUITIES OR PENSIONS**

1. Cost of annuity (total amount you paid in)	\$	4. Total amount received this year	\$
2. Amount received tax-free in prior years		5. Excess, if any, of line 4 over line 3	
3. Remainder of your cost (line 1 less line 2)	\$	6. Enter line 5, or 3 percent of line 1, whichever is greater. (Attach separate schedule for each additional annuity or pension)	\$

**Schedule B.—INCOME FROM RENTS AND ROYALTIES**

1. Kind of property	2. Amount of rent or royalty	3. Depreciation or depletion (explain in Schedule F)	4. Repairs (explain in Schedule G)	5. Other expenses (explain in Schedule G)
	\$	\$	\$	\$
Net profit (or loss) (col. 2 less sum of cols. 3, 4, and 5)				
	\$	\$	\$	\$

**Schedule C.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION.** (Farmers should obtain Form 1040F)

(State (1) nature of business .....; (2) business name .....)

1. Total receipts	\$	<b>OTHER BUSINESS DEDUCTIONS</b>	
<b>COST OF GOODS SOLD</b> (To be used where inventories are an income-determining factor) (Enter the lesser "C" or "M" on lines 2 and 3 if inventories are valued at either cost, or cost or market, whichever is lower)		11. Salaries and wages not in line 4	\$
2. Inventory at beginning of year	\$	12. Interest on business indebtedness	
3. Merchandise bought for sale		13. Taxes on business and business property	
4. Labor		14. Losses (explain in Schedule G)	
5. Material and supplies		15. Bad debts arising from sales or services	
6. Other costs (explain in Schedule G)		16. Depreciation, obsolescence and depletion (explain in Schedule F)	
7. Total of lines 2 to 6	\$	17. Rent, repairs, and other expenses (explain in Schedule G)	
8. Less inventory at end of year		18. Amortization of emergency facilities (attach statement)	
9. Net cost of goods sold (line 7 less line 8)	\$	19. Net operating loss deduction (attach statement)	
10. Gross profit (line 1 less line 9)	\$	20. Total of lines 11 to 19	\$
		21. Total of lines 9 and 20	\$
		22. Net profit (or loss) (line 1 less line 21)	

**Schedule D.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS, ETC.**

1. Net gain (or loss) from sale or exchange of capital assets (from separate Schedule D)	
2. Net gain (or loss) from sale or exchange of property other than capital assets (from separate Schedule D)	

**Schedule E.—INCOME FROM PARTNERSHIPS, ESTATES AND TRUSTS, AND OTHER SOURCES**

Name and address of partnership, syndicate, etc.	Amount
Name and address of estate or trust	Amount
Other sources (state nature)	Amount
Total	

**Total income from above sources (Enter as item 4, page 1)**

**Schedule F.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES B AND C**

1. Kind of property (If buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (do not include land or other nondepreciable property)	4. Assets fully depreciated in any at end of year	5. Depreciation allowed (or allowable) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in computing depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
		\$	\$	\$	\$			\$

**Schedule G.—EXPLANATION OF COLUMNS 4 AND 5 OF SCHEDULE B, AND LINES 6, 14, AND 17 OF SCHEDULE C**

1. Column or Line No.	2. Explanation	1. Amount	1. Column or Line No.	2. Explanation	1. Amount
		\$			\$



### Power of Attorney

Know All Men by These Presents:

That the undersigned, Burnham Enersen, does hereby make, constitute and appoint Henry D. Costigan, Stanley Morrison and Gordon M. Weber, the address of all of whom is 351 California Street, San Francisco, California, jointly, and each of them severally, his true and lawful attorney and attorneys, for him and in his name, place and stead, to prepare, execute and file returns and amended returns for the undersigned for the calendar years 1944 and 1945 under the Revenue Acts of the United States of America; to appear before the Treasury Department of the United States and the Bureau of Internal Revenue and other bureaus, agencies, officers and agents of said Department, before the United States Tax Court, before any board or commission, and before any court or courts of any state or of the United States, and to represent the undersigned in all matters arising out of or in any respect connected with any or all returns or amended returns heretofore or hereafter filed by him, or relating to the determination of such taxes, if any, as may be found to be due from him under any Revenue Act or Acts of the United States of America for the said calendar years 1944 and 1945; to have access to and examine all documents and data in the possession of said Treasury Department, or any bureau, agency, officer or agent of said Department, or said Tax Court, or any board or commission, or any court, with respect to the

liability of the undersigned for federal taxes under any statute of the United States imposing such taxes, and to secure therefrom any and all information relative thereto; to receive but not to endorse and collect checks in settlement of any refund made to the undersigned; to delegate any or all of the authority herein granted; to substitute another agent or attorney, or other agents or attorneys; to execute for him and on his behalf, any waiver or waivers or consent or consents agreeing to a later determination and assessment of taxes than is provided by statutes of limitations, to execute for the undersigned and on his behalf, closing agreements relative to the tax liability of the undersigned; to sign for him and on his behalf, refund, credit or abatement claims, protests, letters, petitions on appeal, pleadings and any other papers or documents whatsoever in connection with said taxes; provided that the enumeration herein of specific powers shall not be construed as a limitation upon the authority of said attorneys and each of them to do any act which the undersigned might lawfully do.

Giving and Granting unto his said attorneys, and to each of them severally, full power and authority to do and perform every act and thing whatsoever necessary or convenient to be done in the premises as fully to all intents and purposes as the undersigned might do or could do, with full power of substitution or revocation, hereby ratifying and confirming all that his said attorneys, or any of them or their substitute or substitutes, or the sub-



stitute or substitutes of any of them, shall lawfully do or cause to be done by virtue thereof.

And the undersigned does hereby revoke all powers of attorney heretofore given for the foregoing purposes.

In Witness Whereof, the undersigned has hereunto subscribed his name, this 14th day of May, 1948.

Executed in Triplicate.

/s/ BURNHAM ENERSEN.

State of California,

City and County of San Francisco—ss.

On this 14th day of May, 1948, before me, Chalmer Munday, a Notary Public in and for the City and County of San Francisco, State of California, residing therein, duly commissioned and sworn, personally appeared Burnham Enersen, known to me to be the person described in and whose name is subscribed to and who executed the within and foregoing instrument, and acknowledged to me that he executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal at my office in said City and County and State the day and year in this certificate first above written.

[Seal]      /s/ CHALMER MUNDAY,  
Notary Public in and for the City and County of  
San Francisco, State of California.

Schedule Attached to  
United States Individual Income Tax Return  
1945

Burnham Enersen

Note: The income reported hereon is one-half of the community income of taxpayer and wife, and all deductions shown are one-half of their total deductions. The other one-half of such income and deductions is reported on the return of taxpayer's wife, Nina W. Enersen.

Page 3:

		One-Half Reported Hereon
<b>Contributions:</b>		
Share of Firm Contributions .....	\$ 596.47	
Carleton College .....	12.00	
American Red Cross .....	50.00	
California State Automobile Assn. ....	12.00	
Commonwealth Club of California .....	14.00	
U. S. Coast Guard League .....	3.00	
Stanford Convalescent Home Auxiliary .....	5.00	
A. F. & A. M .....	4.00	
Golden Gate Kindergarten Auxiliary .....	3.00	
	<hr/>	
	\$ 699.47	\$ 349.74
<b>Interest:</b>		
Richard C. Lindsay .....	\$ 88.50	
Bank of Montreal (S.F.) .....	65.02	
Bankers Life Insurance Company .....	42.90	
Prudential Insurance Company .....	37.50	
Equitable Life Assurance Soc. ....	32.25	
Penn Mutual Insurance Company .....	11.40	
New York Life Insurance Company .....	8.75	
	<hr/>	
	\$ 286.32	143.16
<b>Taxes:</b>		
California Auto License and Tax .....	\$ 8.70	
California personal income tax:		
Nina W. Enersen .....	39.16	
Burnham Enersen .....	39.16	
San Francisco personal property tax .....	2.35	
California Sales Taxes (estimated) .....	50.00	
	<hr/>	
	\$ 139.37	69.68

## Miscellaneous:

## Bar Association dues:

American Bar .....	\$ 8.00	
California Bar .....	10.00	
San Francisco Bar .....	18.00	
Assn. of I.C.C. Practitioners .....	7.00	43.00
<hr/>		
Depreciation on law books .....	4.11	
Safe deposit box rent and tax .....	4.80	
Entertainment expense* .....	100.00	
<hr/>		
	\$ 151.91	\$ 75.96

\* Commercial Club dues and charges totalled \$365.42 for the year. At least \$100 of this amount represented the cost of entertaining clients and other business guests.

## Computation of Reduction in Tax under Section 107 of I.R.C.

Tax on entire net income at 1945 rates (page 3, Item 11) .....	\$4,556.72
Net Income (page 3, Item 3) .....	\$14,699.40
Less: Share of Partnership fees allocable	
to prior years .....	4,841.98
<hr/>	
Balance taxable at 1945 rates .....	\$ 9,857.42
<hr/>	
Tax thereon at 1945 rates .....	\$2,532.24
<hr/>	
Portion of tax attributable to income allocated to prior years....	\$2,024.48
Tax on income allocated to prior years:	

Taxable Year	Income Allocated	Tax	
1944.....	\$1,508.42	\$385.62	
1943.....	1,508.41	403.80	
1942.....	699.16	37.41	
1941.....	59.36	7.48	
1940.....	76.62	6.21	
1939.....	82.50	2.97	
1938.....	78.91	2.84	
1937.....	78.91	2.84	
1936.....	78.91	2.84	
1935.....	78.92	2.84	
1934.....	157.83	5.68	
1933.....	157.83	6.31	
1932.....	157.83	6.31	
1931.....	118.37	1.33	
<hr/>		<hr/>	
	\$4,841.98	\$874.48	874.48
<hr/>		<hr/>	

Reduction in tax pursuant to Section 107 (Page 3 - Item 14)....\$1,150.00

## Deductions

## Contributions

See Attachment .....\$349.74

Allowable Contributions (not in excess of

15 percent of item 5, page 1) .....\$ 349.74

## Interest

See Attachment .....\$143.16

Total Interest ..... 143.16

## Taxes

See Attachment .....\$ 69.68

Total Taxes ..... 69.68

Losses from fire, storm, shipwreck, or other casualty, or theft.

[No information shown.]

Medical and dental expenses

[No information shown.]

Miscellaneous (See Instructions)

See Attachment .....\$ 75.96

Total Miscellaneous Deductions ..... 75.96

Total Deductions .....\$ 638.54

## Tax Computation—For Persons Not Using Tax Table on Page 4

1. Enter amount shown in item 5, page 1. This is your Adjusted Gross Income .....\$15,337.94
2. Enter Deductions (if deductions are itemized above, enter the total of such deductions; if adjusted gross income (line 1, above) is \$5,000 or more and deductions are not itemized, enter the standard deduction of \$500) ..... 638.54
3. Subtract line 2 from line 1. Enter the difference here. This is your Net Income .....\$14,699.40
4. Enter your Normal-Tax Exemption (\$500 if return includes income of only one person; otherwise see Tax Computation Instructions).. 500.00
5. Subtract line 4 from line 3. Enter the difference here. (If line 3 includes partially tax-exempt interest, see Tax Computation instructions) .....\$14,199.40



6. Enter here 3 percent of line 5. This is your Normal Tax.  
(Figure your Surtax below and enter in line 10) ..... \$ 425.98
  7. Copy the figure you entered on line 3, above ....\$14,699.40
  8. Enter your Surtax Exemptions (\$500 for each  
person listed in item 1, page 1) ..... 1,000.00
  9. Subtract line 8 from line 7. Enter the dif-  
ference here. This is your Surtax Net income..\$13,699.40
  10. Use the Surtax Table in instruction sheet to figure your  
Surtax on amount entered on line 9. Enter the  
amount here ..... 4,130.74
  11. Add the figures on lines 6 and 10, and enter the total  
here. (If alternative tax computation is made on sepa-  
rate Schedule D, enter here tax from line 15 of  
Schedule D) .....\$4,556.72
- If you used the \$500 standard deduction in line 2, disregard  
lines 12, 13, and 14, and copy on line 15 the same figure  
you entered on line 11.
12. Enter here any income tax payments to a foreign  
country or U. S. possession (attach Form 1116).
  13. Enter here any income tax paid at source on tax-free  
covenant bond interest.
  14. Reduction under Section 107 ..... 1,150.00
  15. Subtract line 14 from line 11. Enter the difference here  
and in item 6, page 1. This is your tax .....\$3,406.72

Balfour Building,  
351 California Street,  
San Francisco, California.

May 14, 1948.

This Is to Certify that I have not entered into a contingent or partially contingent fee agreement for the representation before the Treasury Department of Burnham Enersen in the matter of Federal taxes for the calendar years 1944 and 1945, under the terms of a Power of Attorney filed with said Department on.....

/s/ HENRY D. COSTIGAN,

/s/ STANLEY MORRISON,

/s/ GORDON M. WEBER.

Admitted November 7, 1949.

---

Mr. Crouter: The 1944 return of Nina W. Enersen as Exhibit G.

The Court: Received in evidence, as Exhibit G.

(Whereupon the document was marked for identification as Exhibit G and was received in evidence.)

Mr. Crouter: And the 1945 return of Nina W. Enersen as Exhibit H.

The Court: Received in evidence as Exhibit H.

(Whereupon the document was marked for identification as Exhibit H and was received in evidence.)

Mr. Crouter: That is all and Respondent rests.

The Court: The original briefs in this proceeding will be due on January the 28th, and the reply briefs—I beg your pardon—December 28, 1949, and the reply briefs will be due on January 16, 1950.

Mr. Crouter: Thank you.

Mr. Costigan: If your Honor please, we have a little difficulty on reply briefs out here, because the Clerk of the Tax Court never sends them air mail and they often take as much as a week to reach us after they are served, and I was wondering if we could have a little more time on reply briefs, even at the expense of having less on the opening brief.

The Court: Well, the time has already been extended. Under our rules the date would be January 6 for the reply brief, but I am willing to add something to that.

If you will refer to the calendar, Mr. Baird, will you give me another ten days on that and just be sure that it doesn't fall on Sunday or Saturday.

The Clerk: The 26th, your Honor, is during the week and also the 27th.

The Court: Reply briefs will be due January 26.

Mr. Costigan: Thank you.

The Court: The case stands submitted. Thank you very much.

(Whereupon, at 2:50 o'clock p.m., the hearing in the above-entitled matter was concluded.)

## Certificate

I, Franklin R. Greene, one of the official reporters of The Tax Court of the United States under its reporting contract, assigned to report certain proceedings during the session of The Tax Court in San Francisco, California, beginning November 7, 1949, do hereby Certify as follows:

That I reported all of the proceedings in the case of Burnham Enersen, Petitioner, Docket No. 20978 and Nina W. Enersen, Petitioner, Docket No. 20979, on November 7, 1949, before the Honorable Marion J. Harron, Judge of The Tax Court.

That I did well and truly, to the best of my ability, record in Stenotype fully, completely and accurately all of the proceedings which I was assigned to report, including all colloquy and statements made during the proceedings, and all questions to and answers given by witnesses;

That my stenotype record is full, complete and accurate; and

That the foregoing record is a true, complete and accurate transcript of my stenotype notes of all the proceedings which I reported, and all of the testimony which was taken in the above-entitled cause.

/s/ FRANKLIN R. GREENE,  
Reporter.

Date: Nov. 23, 1949.

Filed T.C.U.S. December 7, 1949.



## The Tax Court of the United States

[Title of Causes.]

Docket Nos. 20978, 20979

HENRY D. COSTIGAN, ESQ., and  
GORDON M. WEBER, ESQ.,

For the Petitioners.

EARL C. CROUTER, ESQ.,

For the Respondent.

MEMORANDUM FINDINGS OF FACT  
AND OPINION

Harron, Judge:

The Commissioner has determined deficiencies in  
income tax as follows:

Docket No. 20978—1944	.....\$	237.38
1945	.....	1,150.00
Docket No. 20979—1944	.....	257.38
1945	.....	983.37

These proceedings have been consolidated for trial  
and opinion.

The only issue is whether the petitioner, Burnham Enersen, as a member of a law partnership is entitled to apply section 107, Internal Revenue Code, so as to include in the time of the rendition of the services the period prior to his admission to the partnership. The respondent has held that the petitioner is not entitled to receive the benefit of section 107, as amended, because he had not been a member of a partnership for 36 months.

### Findings of Fact

The facts which have been stipulated are hereby found as facts. The facts which are necessary for an understanding of the question are as follows:

Burnham Enersen, hereinafter called "petitioner," and Nina W. Enersen, his wife, reside in San Francisco, California. They filed their income tax returns for the years involved with the collector for the first district of California.

Petitioner is an attorney at law. From 1930 to August 1, 1943, the petitioner was employed continuously by a law partnership in San Francisco. He was admitted to partnership in the firm on August 1, 1943, and since that date he has been a partner in the firm. Upon his admission to partnership, he became entitled to share in fees received thereafter for services rendered by the firm over periods of several years.

From the time of his first employment by the firm in 1930 or 1931 until January 1, 1940, the petitioner was paid a monthly salary plus an annual Christmas bonus amounting to a part of a month's salary. From January 1, 1940 to August 1, 1943, the amount of petitioner's compensation from the partnership was fixed in accordance with certain agreements which covered a calendar year, or portion thereof. Under these agreements, a minimum salary was guaranteed, and above the guaranteed amount a percentage of net profits was paid. During the years 1940, 1941, 1942, and 1943, up to August first, the petitioner received the guaranteed

salary, plus a percentage of profits at the end of each year.

From and after August 1, 1943, the petitioner as a partner in the partnership, has at all times received a specified percentage of the net profits of the partnership, namely,  $3\frac{1}{2}$  per cent from August 1, 1943, to December 30, 1945. The percentage was increased to 5.4571 per cent on December 31, 1945.

The petitioner and his wife and the law partnership have at all times followed the cash method of accounting in the keeping of accounts and the making of income tax returns; and, also, have made their respective tax returns on a calendar year basis.

During 1944 and 1945, the partnership received fees from clients of which 80 per cent of the fees received in each of those years represented compensation for personal services of the firm to clients which had been rendered by the firm over a period of 36 months or more. In the case of the largest amount of such fees which the firm received in 1944, petitioner had performed services for clients in the matters involved during the period from January, 1940 to January, 1944; and in the case of the largest amount of such fees received in 1945, petitioner had performed services for the clients involved during the period from September, 1943, to December, 1945. In accordance with agreed percentages for the sharing in such fees by partners and employees who were employed on a percentage-of-profits basis, the petitioner received \$3,561.13 in 1944; and \$10,791.68 in 1945, as his share of the above fees which the firm received in 1944 and



1945; i.e., of fees for personal services performed over periods of 36 months or more of which fees, 80 per cent or more, were received in a single taxable year.

The petitioner and his wife were married in 1935, and have resided together in California since their marriage, including the years 1944 and 1945. The above amounts of the shares of the petitioner in the fees above described which were received in 1944 and 1945, constituted community property acquired subsequent to 1927.

### Opinion

The petitioner reported his income and computed his tax for the years 1944 and 1945 under the provisions of section 107, Internal Revenue Code, as amended, as though the payments in question (aggregating \$3,561.33 in 1944, and \$10,791.68 in 1945) had been received by him ratably over the period during which the services had been rendered.

He also took into consideration in making the ratable allocation the fact that during the period 1935 through 1945, he was married and his income was part of the community property of himself and his wife; but with respect to this aspect of the issue in this proceeding, no issue is presented.

The respondent, in the notice of deficiency, determined that the entire amount of the shares of petitioner in the fees which were received in 1944 and 1945 were taxable in 1944 and 1945 as ordinary income received in full in those years, upon his holding that the petitioner did not qualify for relief



under section 107(a) with respect to fees earned since August 1, 1943, because the period of the petitioner's membership in the partnership was less than 36 calendar months. The respondent has not questioned the allocation of the income in question over prior years, so that we assume that if the question presented is decided in the petitioners' favor, there are no deficiencies in the taxable years.

The question presented is whether section 107, in the form in which it was applicable to the years before us, contemplates allocation of compensation for personal services rendered by a partnership over the entire period of rendition of the services, notwithstanding that the taxpayer-partner who shares in the compensation was not a member of the partnership during all of that period.

The same question was presented for decision in the proceeding of Elder W. Marshall, et al., Docket Nos. 23432 and 23433. Our opinion in that proceeding was promulgated on January 27, 1950. See 14 T.C. No. 12. There, as here, the respondent eliminated the entire amount of the share of the taxpayer in fees from the scope of section 107 on the ground that by the end of the year in which the income was received, the taxpayer had not actually been a member of a law firm for the 36-month period which the statute prescribes.

The facts in this proceeding present an even stronger case for the petitioner than did the facts in the Marshall case, because in this proceeding the taxpayer rendered services over a period of several years for which the fees in which he shared, in 1944

and 1945, were paid by clients as compensation for personal services; and, also, he has been associated with the law firm in question throughout the period of years over which he seeks to allocate the income in question.

In *Elder W. Marshall, supra*, this Court rejected the same argument which the respondent has advanced in this proceeding. In so doing, we took into consideration the language of section 107 before and after the 1942 amendment, and the Congressional intent as shown by Senate Report No. 1631, 77th Cong., 2d sess., 109, to which the petitioner calls attention. It is unnecessary to repeat here what we have said in the Opinion in the proceeding of *Elder W. Marshall, supra*. It is held, therefore, that the respondent's determination in this proceeding whereby he has eliminated allocation where the partnership status did not extend over three years is erroneous. As we said in *Elder W. Marshall, supra*:

Since it is the status of the recipient of the income in the year of receipt, and not either his status in prior years, *Federico Stallforth*, 6 T.C. 140, nor the identity of the individual who contributed the services, that is made to govern the application of section 107 in its present form, we are satisfied that under the facts of this proceeding petitioner correctly computed his tax by use of its provisions.

Decisions will be entered that there are no deficiencies.

[Seal].

Received T.C.U.S. January 18, 1950.

Entered Jan. 26, 1950.

The Tax Court of the United States  
Washington

Docket No. 20978

BURNHAM ENERSEN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in the Memorandum Findings of Fact and Opinion, entered on January 26, 1950, it is

Ordered and Decided: That there are no deficiencies in income tax for the years 1944 and 1945.

[Seal]     /s/ MARION J. HARRON,  
Judge.

Entered Jan. 27, 1950.

Served Jan. 27, 1950.

The Tax Court of the United States

Washington

Docket No. 20979

NINA W. ENERSEN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## DECISION

Pursuant to the determination of the Court, as set forth in its the Memorandum Findings of Fact and Opinion, entered on January 26, 1950, it is

Ordered and Decided: That there are no deficiencies in income tax for the years 1944 and 1945.

[Seal]     /s/ MARION J. HARRON,  
Judge.

Entered Jan. 27, 1950.

Served Jan. 27, 1950.



In the United States Court of Appeals  
for the Ninth Circuit

Docket No. 20978

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner on Review,

vs.

BURNHAM ENERSEN,  
Respondent on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States Court  
of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by The Tax Court of the United States on January 27, 1950, ordering and deciding that there are no deficiencies in income tax for the years 1944 and 1945. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The respondent, Burnham Enersen, and Nina W. Enersen, his wife, reside in San Francisco, California. They filed their Federal income tax returns for the calendar years 1944 and 1945 with the Collector of Internal Revenue for the First District of California, whose office is located at San Francisco, California, and within the judicial circuit of the United States Court of Appeals for the Ninth Circuit, where this review is sought.

### Nature of Controversy

The issue is whether the taxpayer, Burnham Enersen, as a member of a law partnership is entitled to apply Section 107, Internal Revenue Code, so as to include in the time of the rendition of the services the period prior to his admission to the partnership.

The taxpayer, Burnham Enersen, is an attorney at law. From 1930 to August 1, 1943, he was employed continuously by a law partnership in San Francisco. He was admitted to partnership in the firm on August 1, 1943, and since that date he has been a partner in the firm. Upon his admission to partnership, he became entitled to share in fees received thereafter for services rendered by the firm over periods of several years. The taxpayer received \$3,561.13 in 1944 and \$10,791.68 in 1945 as his share of the fees which the firm received in 1944 and 1945; i.e., of fees for personal services performed over periods of 36 months or more of which fees, 80 per cent or more, were received in a single taxable year.

The taxpayer reported his income and computed his tax for the years 1944 and 1945 under the provisions of Section 107, Internal Revenue Code, as amended, as though the payments in question had been received by him ratably over the period during which the services had been rendered. The Commissioner determined that the entire amount of the shares of taxpayer in the fees which were received in 1944 and 1945 were taxable in 1944 and 1945 as ordinary income received in full in those years, for the reason that the taxpayer did not qualify for re-

lief under Section 107(a) with respect to fees earned since August 1, 1943, because the period of taxpayer's membership in the partnership was less than 36 calendar months.

The Tax Court, however, decided in favor of the taxpayer on the authority of its decision in *Elder W. Marshall, et al.*, 14 T. C. No. 12, and held that the Commissioner's determination whereby he has eliminated allocation where the partnership status did not extend over three years is erroneous.

/s/ THERON L. CAUDLE, C.A.R.,  
Assistant Attorney General.

/s/ CHARLES OLIPHANT, C.A.R.,

Chief Counsel, Bureau of Internal Revenue, Counsel for Petitioner on Review.

Received and Filed T. C. U. S. April 21, 1950.

---

[Title of Court of Appeals and Cause.]

Docket No. 20978

NOTICE OF  
FILING PETITION FOR REVIEW

To: Mr. Burnham Enersen,  
2642 Baker Street,  
San Francisco, California.

You are hereby notified that the Commissioner of Internal Revenue did, on the 21st day of April, 1950, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for

the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 21st day of April, 1950.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of Internal Revenue, Coun-  
sel for Petitioner on Review.

Personal service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 24th day of April, 1950.

/s/ BURNHAM ENERSEN,  
Respondent on Review.

Received and Filed T. C. U. S. May 5, 1950.

---

[Title of Court of Appeals and Cause.]

Docket No. 20978

NOTICE OF  
FILING PETITION FOR REVIEW

To: Henry D. Costigan, Esq.,  
Gordon M. Weber, Esq.,  
1500 Balfour Building,  
San Francisco 4, California.

You are hereby notified that the Commissioner of Internal Revenue did, on the 21st day of April, 1950, file with the Clerk of The Tax Court of the



United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 21st day of April, 1950.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of Internal Revenue, Coun-  
sel for Petitioner on Review.

Personal service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 24th day of April, 1950.

/s/ HENRY D. COSTIGAN,  
Counsel for Respondent on  
Review.

Received and Filed T. C. U. S. May 5, 1950.

---

[Title of District Court and Cause.]

Docket No. 20979

## PETITION FOR REVIEW

To the Honorable Judges of the United States Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue hereby petitions the United States Court of Appeals for the Ninth Circuit to review the decision entered by The Tax Court of the United States on January 27, 1950, ordering and deciding that there are no deficiencies

in income tax for the years 1944 and 1945. This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

The respondent, Nina W. Enersen, and Burnham Enersen, her husband, reside in San Francisco, California. They filed their Federal income tax returns for the calendar years 1944 and 1945 with the Collector of Internal Revenue for the First District of California, whose office is located at San Francisco, California, and within the judicial circuit of the United States Court of Appeals for the Ninth Circuit, where this review is sought.

### Nature of Controversy

The issue is whether taxpayer's husband, Burnham Enersen, as a member of a law partnership is entitled to apply Section 107, Internal Revenue Code, so as to include in the time of the rendition of the services the period prior to his admission to the partnership.

The taxpayer's husband, Burnham Enersen, is an attorney at law. From 1930 to August 1, 1943, he was employed continuously by a law partnership in San Francisco. He was admitted to partnership in the firm on August 1, 1943, and since that date he has been a partner in the firm. Upon his admission to partnership, he became entitled to share in fees received thereafter for services rendered by the firm over periods of several years. Burnham Enersen received \$3,561.13 in 1944 and \$10,791.68 in 1945 as his share of the fees which the firm received in 1944

and 1945; i.e., of fees for personal services performed over periods of 36 months or more of which fees, 80 per cent or more, were received in a single taxable year.

The income in question constituted community property, and the taxpayer and her husband reported their income and computed their tax for the years 1944 and 1945 under the provisions of Section 107, Internal Revenue Code, as amended, as though the payments in question had been received ratably over the period during which the services had been rendered. The Commissioner determined that the income in question was taxable in 1944 and 1945 as ordinary income received in full in those years, for the reason that the taxpayer and her husband did not qualify for relief under Section 107(a) with respect to fees earned since August 1, 1943, because the period of Burnham Enersen's membership in the partnership was less than 36 calendar months.

The Tax Court, however, decided in favor of the taxpayer on the authority of its decision in *Elder W. Marshall, et al.*, 14 T. C. No. 12, and held that the Commissioner's determination whereby he had eliminated allocation where the partnership status did not extend over three years is erroneous.

/s/ THERON L. CAUDLE, C.A.R.,  
Assistant Attorney General.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of Internal Revenue, Counsel  
for Petitioner on Review.

Received and Filed T. C. U. S. April 21, 1950.



[Title of Court of Appeals and Cause.]

Docket No. 20979

NOTICE OF  
FILING PETITION FOR REVIEW

To: Mrs. Nina W. Enersen,  
2642 Baker Street,  
San Francisco, California.

You are hereby notified that the Commissioner of Internal Revenue did, on the 21st day of April, 1950, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 21st day of April, 1950.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of Internal Revenue, Counsel  
for Petitioner on Review.

Personal service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 24th day of April, 1950.

/s/ NINA W. ENERSEN,  
Respondent on Review.

Received and Filed T. C. U. S. May 5, 1950.



[Title of Court of Appeals and Cause.]

Docket No. 20979

NOTICE OF  
FILING PETITION FOR REVIEW

To: Henry D. Costigan, Esq.,  
Gordon M. Weber, Esq.,  
1500 Balfour Building,  
San Francisco 4, California.

You are hereby notified that the Commissioner of Internal Revenue did, on the 21st day of April, 1950, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 21st day of April, 1950.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of Internal Revenue, Counsel  
for Petitioner on Review.

Personal service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 25th day of April, 1950.

/s/ GORDON M. WILEY,  
Counsel for Respondent on  
Review.

Received and Filed T. C. U. S. May 5, 1950.

[Title of Court of Appeals and Cause.]

Docket Nos. 20978, 20979

### MOTION

Comes Now the Commissioner of Internal Revenue, petitioner on review in the above-entitled causes, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and moves that the time within which to complete and transmit the record on review be extended from May 31, 1950, to and including July 20, 1950, and for cause respectfully represents:

That the question as to whether the petitions for review will be further prosecuted is under consideration and therefore additional time is required in order to complete this consideration and also if necessary to properly stipulate the omissions, if any, from the record on review, to prepare the record and to transmit it to the Court of Appeals.

Wherefore, it is prayed that this motion be granted.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

J. M. MORAWSKI,  
Special Attorney,  
Bureau of Internal Revenue.

Received and Filed T. C. U. S. May 24, 1950.

The Tax Court of the United States  
Washington

Dockets Nos. 20978, 20979

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner,  
vs.

BURNHAM ENERSEN, NINA W. ENERSEN,  
Respondents.

## ORDER ENLARGING TIME

Upon motion of counsel for petitioner, it is

Ordered that the time for preparation, transmission and delivery of the record sur petition for review of the above-entitled proceeding in the United States Court of Appeals for the Ninth Circuit is extended to July 20, 1950.

[Seal] /s/ JOHN W. KERN,  
Presiding Judge.

Dated: Washington, D. C., May 24, 1950.

Served May 26, 1950.

United States Court of Appeals  
for the Ninth Circuit

Docket Nos. 20978, 20979

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner on Review,

vs.

BURNHAM ENERSEN, NINA W. ENERSEN,  
Respondents on Review.

### STATEMENT OF POINTS

Comes Now the petitioner on review herein and makes this concise statement of points on which he intends to rely on the review herein, to wit:  
The Tax Court of the United States erred:

1. In holding that the payments in question (aggregating \$3,561.13 for 1944 and \$10,791.68 in 1945), which were received by Burnham Enersen as his share of certain partnership fees, are subject to tax under the provisions of Section 107, Internal Revenue Code, on the authority of the Tax Court's decision in *Elder W. Marshall, et al.*, 14 T. C. No. 12.

2. In failing to uphold the Commissioner's determination that the income in question was taxable as ordinary income in the year received, without the benefits of the relief provided by Section 107, Internal Revenue Code, since Burnham Enersen's membership in the partnership was less than 36 calendar months.



3. In holding in each case that there are no deficiencies in income tax for 1944 and 1945; and in failing to withhold the deficiencies determined by the Commissioner for 1944 and 1945 in the respective amounts of \$237.38 and \$1,150.00 in the case of Burnham Enersen and \$257.38 and \$983.47 in the case of Nina W. Enersen.

4. In that its decisions are not supported by the evidence.

5. In that its decisions are contrary to law and regulations.

/s/ THERON L. CAUDLE, C.A.R.,  
Assistant Attorney General.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of Internal Revenue. Counsel for Petitioner on Review.

Service of a copy of the within statement of points is hereby admitted this 7th day of June, 1950.

/s/ HENRY S. COSTIGAN,  
/s/ GORDON M. WEBER,  
Attorneys for Respondents on  
Review

Received and Filed T. C. U. S. July 3, 1950.

[Title of Court of Appeals and Cause.]

Docket Nos. 20978 and 20979

## STATEMENT RE DIMINUTION OF RECORD

To the Clerk of the Tax Court of the United States:

Pursuant to the provisions of Rule 75(o) of the Federal Rules of Civil Procedure adopted by the United States Court of Appeals for the Ninth Circuit, you are hereby notified that the petitioner on review will not exclude or omit any part of the record in these proceedings which were consolidated for hearing and opinion by the Tax Court.

/s/ THERON L. CAUDLE, C.A.R.,  
Assistant Attorney General.

/s/ CHARLES OLIPHANT, C.A.R.,  
Chief Counsel, Bureau of Internal Revenue, Attorneys for Petitioner on Review.

Service of a copy of this Statement Re Diminution of Record is hereby acknowledged this 7th day of June, 1950.

/s/ HENRY S. COSTIGAN,

/s/ GORDON M. WEBER,  
Attorneys for Respondents on Review.

Received and Filed T. C. U. S. July 3, 1950.

The Tax Court of the United States  
Washington

Docket Nos. 20978 and 20979

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner on Review,

vs.

BURNHAM ENERSEN, NINA W. ENERSEN,  
Respondent on Review.

CERTIFICATE

I, Victor S. Mersch, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 30, inclusive, constitute and are all of the papers and proceedings on file in my office as the original and complete record in the proceedings before the Tax Court of the United States entitled, "Burnham Enersen, Petitioner, v. Commissioner of Internal Revenue, Respondent," Docket No. 20978, and "Nina W. Enersen, Petitioner, v. Commissioner of Internal Revenue, Respondent," Docket No. 20979, and in which the respondents in the Tax Court proceedings have initiated appeals as above numbered and entitled, together with a true copy of the docket entries in said Tax Court proceedings, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 7th day of July, 1950.

[Seal]     /s/ VICTOR S. MERSCH,  
Clerk.

[Endorsed]: No. 12610. United States Circuit Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Burnham Enersen and Nina W. Enersen, Respondents. Transcript of the Record. Upon Petitions to Review Decisions of the Tax Court of the United States.

Filed July 14, 1950.

/s/ PAUL P. O'BRIEN,  
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.



In the United States Court of Appeals  
for the Ninth Circuit

No. 12610

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner,

vs.

BURNHAM ENERSEN,  
Respondent.

COMMISSIONER OF INTERNAL REVENUE,  
Petitioner.

vs.

NINA W. ENERSEN,  
Respondent.

NOTICE AS TO STATEMENT OF POINTS TO  
BE RELIED UPON AND AS TO PARTS  
OF RECORD TO BE PRINTED

Pursuant to Rule 19(6) of the Rules of Practice of the United States Court of Appeals for the Ninth Circuit, notice is hereby given by the Commissioner of Internal Revenue, petitioner on review herein, as follows:

1. The Commissioner hereby adopts, as the Statement of Points upon which he intends to rely on the present review, the Statement of Points heretofore filed and served and included in the certified typewritten transcript of record filed in this Court in this cause; and

2. The Comissioner hereby designates for printing the entire transcript of record filed in this Court in this cause.

Dated this 27th day of July, 1950.

/s/ THERON LAMAR CAUDLE,  
Assistant Attorney General, Counsel for Petitioner  
on Review.

[Endorsed]: Filed U. S. C. A. July 31, 1950.

---

[Title of Court of Appeals and Cause.]

STIPULATION AS TO PARTS OF THE  
RECORD TO BE PRINTED

1. Pursuant to Rule 19(6) of the Rules of Practice of the United States Court of Appeals for the Ninth Circuit, it is hereby stipulated and agreed by and between the parties to this cause, through their respective counsel, that, in lieu of the parts of the record heretofore designated for printing by the petitioner on review by his notice dated July 27, 1950, heretofore served and filed in this cause in this Court, only the following parts of the transcript of record filed in this Court in this cause be printed, as material to the consideration of the review:

	Document No.*
(a) Docket Entries in T. C. Docket #20978...	1
(b) Docket Entries in T. C. Docket #20979...	2
(c) Petition in T. C. Docket #20978.....	3
(d) Answer in T. C. Docket #20978.....	5
(e) Stipulation of Facts in T. C. Docket Nos. 20978 and 20979.....	14
(f) Joint Exhibits 1-A thru 4-D Attached to Stipulation of Facts.....	15
(g) Respondent's Exhibit E and F (part of Document No. 16) .....	16
(h) Official Report of Proceedings in T. C. Docket Nos. 20978 and 20979.....	17
(i) Memorandum Findings of Fact and Opinion in T. C. Docket Nos. 20978 and 20979....	22
(j) Decision in T. C. Docket #20978.....	23
(k) Decision in T. C. Docket #20979.....	24
(l) Petition for Review and Proofs of Service in T. C. Docket #20978.....	25
(m) Petition for Review and Proofs of Service in T. C. Docket #20979.....	26

---

\*This refers to the number given to the respective parts of the transcript of record on review by the Clerk of the Tax Court in transmitting it to the Clerk of the Court of Appeals.

(n) Motion for Extension of Time to Prepare Record on Review in T. C. Docket Nos. 20978 and 20979.....	27
(o) Order Enlarging Time to Prepare and Transmit Record in T. C. Docket Nos. 20978 and 20979.....	28
(p) Statement of Points in T. C. Docket Nos. 20978 and 20979.....	29
(q) Statement re Diminution of Record in T. C. Docket Nos. 20978 and 20979.....	30
(r) Certificate and Seal .....	

2. It is further agreed that, except for immaterial minor differences, the petition, with Exhibit A thereto, and the answer in the case of *Nina W. Enersen v. Commissioner*, T. C. Docket No. 20979, are identical to those in the case of *Burnham Enersen v. Commissioner*, T. C. Docket No. 20978, and it is therefore agreed that they be omitted from the printed record. It is further agreed that Respondent's Exhibits G and H are copies of the income tax returns of Nina W. Enersen for the years 1944 and 1945, respectively, and that they, except for immaterial minor differences, are identical to Respondent's Exhibits E and F, the respective income tax returns of Burnham Enersen for those years, and it is therefore agreed that they be omitted from the printed record.

3. It is further agreed that there also be in-



cluded in the printed record the following documents filed in this Court:

(a) Notice as to Statement of Points, etc., filed by Petitioner on Review.

(b) This Stipulation.

/s/ THERON LAMAR CAUDLE,  
Assistant Attorney General, Counsel for Petitioner  
on Review.

/s/ HENRY S. COSTIGAN,  
Counsel for Respondent on  
Review.

Dated this 17th day of August, 1950.

[Endorsed]: Filed U. S. C. A. August 22, 1950.



No. 12610

---

**In the United States Court of Appeals  
for the Ninth Circuit**

---

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BURNHAM ENERSEN AND NINA W. ENERSEN,  
RESPONDENTS

---

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX  
COURT OF THE UNITED STATES

---

**BRIEF FOR THE PETITIONER**

---

THERON LAMAR CAUDLE,  
*Assistant Attorney General.*

ELLIS N. SLACK,  
HARRY MARSELLI,  
*Special Assistants to the Attorney General.*

---

FILED

APR 9 1950

PAUL P. O'BRIEN,  
CLERK





# INDEX

	Page
Opinion below.....	1
Jurisdiction.....	1
Question presented.....	3
Statute and Regulations involved.....	3
Statement.....	4
Statement of points to be urged.....	8
Summary of argument.....	9
Argument:	
An incoming partner may not, for the purpose of qualifying for the privilege of spreading income back over years prior to the year of its receipt under Section 107 (a) of the Internal Revenue Code, tack on to his period of membership in the partnership the period of services rendered by the partnership prior to his becoming a member.....	11
Conclusion.....	28

## CITATIONS

### Cases:

<i>Black v. Brundige</i> , 125 Cal. App. 641.....	23
<i>Burnet v. Sanford &amp; Brooks Co.</i> , 282 U. S. 359.....	24
<i>Commissioner v. Whitney</i> , 169 F. 2d 562, certiorari denied, 335 U. S. 892.....	27
<i>Coward v. Clanton</i> , 122 Cal. 451.....	23
<i>Heiner v. Mellon</i> , 304 U. S. 271.....	25
<i>Helvering v. Northwest Steel Mills</i> , 311 U. S. 46.....	25
<i>Helvering v. Smith</i> , 90 F. 2d 590.....	27
<i>Krenz, O., C. &amp; B. Wks., Inc. v. England</i> , 109 Cal. App. 747.....	23
<i>Lindstrom v. Commissioner</i> , 149 F. 2d 344.....	9, 14
<i>Lyden v. Spohn-Patrick Co.</i> , 155 Cal. 177.....	23
<i>Marshall v. Commissioner</i> , 14 T. C. 90.....	9, 13
<i>Randolph Products Co. v. Manning</i> , 176 F. 2d 190.....	27
<i>Security Mills Co. v. Commissioner</i> , 321 U. S. 281.....	25
<i>Sievert v. Simonds</i> , 89 Cal. App. 2d 34.....	23
<i>Slough v. Commissioner</i> , 147 F. 2d 836.....	25
<i>Smart v. Commissioner</i> , 152 F. 2d 333, certiorari denied, 327 U. S. 804.....	25
<i>Sovick v. Shaughnessy</i> , 92 F. Supp. 202.....	25
<i>United States v. Amer. Trucking Ass'ns</i> , 310 U. S. 534.....	26

### Statutes:

California Corporation Code, Sec. 15007.....	23
Internal Revenue Code:	
Sec. 107 (26 U. S. C. 1946 ed., Sec. 107).....	3
Secs. 181-190 (26 U. S. C. 1946 ed., Sec. 181-190).....	4
Revenue Act of 1939, c. 247, 53 Stat. 862, Sec. 220.....	14, 20
Revenue Act of 1943, c. 63, 58 Stat. 21, Sec. 119.....	3

Miscellaneous:	Page
88 Cong. Record, Part 6, p. 7810-----	17
G. C. M. 25795, 1948-2 Cum. Bull. 61-----	17
H. Conference Report No. 2586, 77th Cong., 2d Sess., p. 42 (1942-2 Cum. Bull. 701, 706-707)-----	19
H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 90-91 (1942-2 Cum. Bull. 372, 441)-----	17
H. R. 7378, 77th Cong., 2d Sess-----	17
S. Rep. No. 648, 76th Cong., 1st Sess., p. 7 (1939-2 Cum. Bull. 524, 528-529)-----	20
S. Rep. No. 1631, 77th Cong., 2d Sess. (1942-2 Cum. Bull. 504): Pp. 48-49, 108-110-----	18
P. 109-----	18
Treasury Regulations 111, Sec. 29.107-1-----	4

# **In the United States Court of Appeals for the Ninth Circuit**

---

No. 12610

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

BURNHAM ENERSEN AND NINA W. ENERSEN,  
RESPONDENTS

---

*ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX  
COURT OF THE UNITED STATES*

---

## **BRIEF FOR THE PETITIONER**

---

### **OPINION BELOW**

The memorandum findings of fact and opinion of the Tax Court (R. 71-76) are not officially reported.

### **JURISDICTION**

These petitions for review (R. 79-81, 83-85) involve proceedings with respect to deficiencies in income tax determined by the Commissioner against Burnham Enersen (hereinafter referred to as the taxpayer) for the years 1944 and 1945 in the amounts of \$237.38 and \$1,150, respectively (R. 13-20), and against the taxpayer's wife, Nina W. Enersen, for the same years in the amounts of \$257.38 and \$983.37, respectively (R. 24, 71). The taxpayer and his wife are individuals residing in San Francisco, California, and they filed their federal income tax returns for the years

1944 and 1945 with the Collector of Internal Revenue for the First District of California. (R. 23-24, 72.) By letters dated October 26, 1948 (R. 13-20), the Commissioner of Internal Revenue notified the taxpayer and his wife, respectively, that the determination of their income tax liability for the taxable years 1944 and 1945 disclosed deficiencies in the respective amounts above stated.<sup>1</sup> Within 90 days thereafter, namely on November 16, 1948, the taxpayer (R. 2) and his wife (R. 4), respectively, filed with the Tax Court petitions (R. 6-20 and see fn. 1, *supra*) for a redetermination of the deficiencies determined by the Commissioner as above stated, pursuant to Section 272 of the Internal Revenue Code. On January 27, 1950, the Tax Court entered its decisions (R. 77, 78), finding no deficiencies for 1944 and 1945 as to the taxpayer and his wife, respectively. Less than three months thereafter, namely on April 21, 1950 (R. 3, 5), the Commissioner filed his petitions (R. 79-81, 83-85) for a review by this Court of the decisions of the Tax Court, pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

---

<sup>1</sup> The printed record in this Court contains only a copy of the deficiency letter addressed to the taxpayer (R. 13-20), which was attached as Exhibit A to his petition to the Tax Court (R. 6-12). The letter addressed to the wife, which was attached as Exhibit A to her petition in the Tax Court (Docket No. 20979), as well as her petition and the Commissioner's answer, and also the copies of her income tax returns for 1944 and 1945, have been omitted from the printed record by stipulation of the parties, in which it was agreed (R. 98) that, except for immaterial minor differences, they are identical to the corresponding documents in the case of the taxpayer (T. C. Docket No. 20978).



## QUESTION PRESENTED

The question presented is whether an incoming partner may avail himself of Section 107 (a) of the Internal Revenue Code with respect to his share of fees received by a partnership for services performed over a period exceeding 36 months, if he has not been a member of the partnership for 36 months or more at the time of their receipt.

## STATUTE AND REGULATIONS INVOLVED

## Internal Revenue Code:

SEC. 107 [as ~~amended~~ added by Sec. 220 of the Revenue Act of 1939, c. 247, 53 Stat. 862, and by Section 139 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. COMPENSATION FOR SERVICES RENDERED FOR A PERIOD OF THIRTY-SIX MONTHS OR MORE.

(a) *Personal Services*.—If at least 80 per centum of the total compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.

\* \* \* \* \*

(26 U. S. C. 1946 ed., Sec. 107.)

By Section 119 of the Revenue Act of 1943, c. 63, 58 Stat. 21, the words "AND BACK PAY" were added

to the title of Section 107 of the Code, and subsection (d)—containing provisions dealing with “back pay,” not here material—was added to Section 107.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.107-1. *Personal Services.*—

\* \* \* \* \*

It is not necessary, in order for section 107 (a) to be applicable, that the individual who includes in his gross income compensation for such personal services be the person who renders the services. For example, a partner who shares in the compensation for such personal services rendered by the partnership may be entitled to the benefits of section 107 (a), notwithstanding that he took no part in the rendering of such services.

\* \* \* \* \*

**STATEMENT**

The facts in these cases, which were stipulated (R. 23-31)<sup>2</sup> and were found by the Tax Court to be as stipulated (R. 72), were recited by the Tax Court in its memorandum opinion as follows (R. 72-74):

Burnham Enersen, the taxpayer, and Nina W. Enersen, his wife, reside in San Francisco, California. They filed their income tax returns for the years

---

<sup>2</sup> In addition to the stipulation of facts (R. 23-31) and the exhibits attached to and submitted therewith (Joint Exhibits 1-A, 2-B, 3-C and 4-D (R. 35-44)), there were four other exhibits adduced in evidence at the hearing before the Tax Court, Exhibits E and F, the taxpayer's income tax returns for 1944 and 1945, respectively (R. 46-56, 57-68), and Exhibits G and H, the income tax returns of the taxpayer's wife for 1944 and 1945, respectively (R. 68 and see fn. 1, *supra*).

involved with the Collector for the first district of California. (R. 72.)

The taxpayer is an attorney at law. From 1930 to August 1, 1943, the taxpayer was employed continuously by a law partnership in San Francisco. He was admitted to partnership in the firm on August 1, 1943, and since that date he has been a partner in the firm. Upon his admission to partnership, he became entitled to share in fees received thereafter for services rendered by the firm over periods of several years. (R. 72.)

From the time of his first employment by the firm in 1930 or 1931 until January 1, 1940, the taxpayer was paid a monthly salary plus an annual Christmas bonus amounting to a part of a month's salary. From January 1, 1940, to August 1, 1943, the amount of taxpayer's compensation from the partnership was fixed in accordance with certain agreements which covered a calendar year, or portion thereof.<sup>3</sup> Under these agreements, a minimum salary was guaranteed, and above the guaranteed amount a percentage of net profits was paid. During the years 1940, 1941, 1942, and 1943, up to August first, the taxpayer received the guaranteed salary, plus a percentage of profits at the end of each year.<sup>4</sup> (R. 72-73.)

From and after August 1, 1943, the taxpayer, as a partner in the partnership, has at all times received

---

<sup>3</sup> Copies of these agreements were submitted with the stipulation of facts, as Joint Exhibits 1-A, 2-B, 3-C, and 4-D. (R. 35-44.)

<sup>4</sup> The guaranteed salary was paid monthly, while the balance, i. e., up to the amount equalling his specified percentage of profits, was paid at the end of each year. (R. 25.)



a specified percentage of the net profits of the partnership, namely,  $31\frac{1}{2}$  per cent from August 1, 1943, to December 30, 1945. The percentage was increased to 5.4571 per cent on December 31, 1945. (R. 73.)

The taxpayer and his wife and the law partnership have at all times followed the cash method of accounting in the keeping of accounts and the making of income tax returns; and, also, have made their respective tax returns on a calendar year basis. (R. 73.)

During 1944 and 1945, the partnership received fees from clients representing compensation for personal services which had been rendered by the firm over a period of 36 months or more, the amounts received as fees during each year on each case or matter constituting at least 80 per cent of the total compensation therefor.<sup>5</sup> In the case of the largest amount of those fees which the firm received in 1944, the taxpayer had performed services for clients in the matters involved during the period from January, 1940, to January, 1944; and in the case of the largest amount of those fees received in 1945, the taxpayer had performed services for the clients involved during the period from September, 1943, to December, 1945. In accordance with agreed percentages for the sharing in such fees by partners and employees who were employed on a percentage-of-profits basis, the taxpayer received \$3,561.13 in 1944; and \$10,791.68 in 1945, as his share of the above fees which the firm received in 1944 and 1945; i. e., of fees for personal services performed over periods of 36 months or more of which fees,

---

<sup>5</sup> The recital of this fact by the Tax Court in its opinion is not clear, but see paragraph 11 of the stipulation. (R. 26.)



80 per cent or more were received in a single taxable year. (R. 73-74.)

The taxpayer and his wife were married in 1935, and have resided together in California since their marriage, including the years 1944 and 1945. The above amounts of the shares of the taxpayer in the fees above described which were received in 1944 and 1945, constituted community property acquired subsequent to 1927. (R. 74.)

The taxpayer reported his income and computed his tax for the years 1944 and 1945 under the provisions of Section 107 of the Internal Revenue Code, as amended, as though his share of the long-term fees in question, aggregating \$3,561.33 in 1944 and \$10,791.68 in 1945, had been received by him ratably over the period during which the services had been rendered. He also took into consideration, in making the allocation, the fact that during the period from 1935 through 1945 he was married and his income was part of the community property of himself and his wife.<sup>6</sup> (R. 74.)

---

<sup>6</sup> The taxpayer reported one half of his share of the long-term fees in question, allocated over the years of the services, in his returns for 1944 and 1945 in computing his tax thereon under Section 107 (R. 28-29, 30-31, 53, 64, 65), and his wife reported the other half in her returns (R. 30-31)—with the exception that, as to the fees received in 1945, which were for services extending from 1931 to 1945, the taxpayer reported in his own return all of the amounts allocated to the years 1931 to 1934, which preceded his marriage (1935). No question was raised as to their dividing this income, or the rest of the income from the law partnership in 1944 and 1945 (See R. 15-19, 53, 64), between them as community income (R. 74)—nor was there any controversy between the parties as to *amounts* of income or as to *computations* of the resultant tax liabilities under their respective positions, the only controversy being as to *the right* to allocate to any prior years

The Commissioner, in his notice of deficiency, determined that the entire amount of the shares of the taxpayer in the long-term fees which were received in 1944 and 1945 was taxable in each of those years in full as ordinary income, the Commissioner holding that the taxpayer did not qualify for relief under Section 107 (a) of the Internal Revenue Code because the period of his membership in the partnership at the time of the receipt of the fees was less than 36 calendar months. (R. 16-17, 19, 74-75.)

The Tax Court, by a memorandum opinion by Judge Harron (R. 71-76), decided in favor of the taxpayer, and accordingly entered its decisions that there are no deficiencies for the years in question (R. 77, 78). The present reviews followed.

#### STATEMENT OF POINTS TO BE URGED

On the present reviews, the Commissioner urges and relies upon all of the points originally stated and set out by him (R. 90-91) and subsequently adopted by him in this Court (R. 95) as the points upon which he

---

under Section 107 (a) of the Code any portion of the taxpayer's share of the fees for long-term services received by the partnership in 1944 and 1945 (R. 16-17, 18-19). The statement in the Tax Court's opinion that the Commissioner "has not questioned the allocation of the income in question over prior years" (R. 75) is correct only if construed to refer to the *computation* of the allocation of the income to prior years under Section 107 (a): The Commissioner in his determinations and before the Tax Court did, and does here, deny *the right* to allocate any part of the taxpayer's share of the long-term fees to any prior years *at all* on the ground that the taxpayer, having been a member of the partnership for less than 36 months when the fees in question were received by the partnership, does not qualify for Section 107 (a) treatment.

intends to rely. For present purposes, they may be briefly stated as follows: (1) The Tax Court erred in holding that the taxpayer's shares of the partnership fees in question are subject to tax under the provision of Section 107 of the Internal Revenue Code; and (2) the Tax Court erred in failing to uphold the Commissioner's determination that the income in question was taxable as ordinary income in the years received, without the benefit of Section 107 of the Internal Revenue Code, since the taxpayer's membership in the partnership was less than 36 months.

#### SUMMARY OF ARGUMENT

The Commissioner correctly determined that as to the fees for long-term services received by the law firm in 1944 and 1945 the taxpayer was not entitled to allocate any portion of his share to any prior taxable years at all, under Section 107 (a) of the Code, because the taxpayer had not been a partner for 36 months or more at the time of their receipt. The Tax Court was clearly in error in not sustaining the Commissioner. The decision of the Tax Court is contrary to the holding of this Court in *Lindstrom v. Commissioner*, 149 F. 2d 344, which is applicable and controlling here, and it should therefore be reversed.

In deciding this case, the Tax Court followed the holding of the majority of the Tax Court in *Marshall v. Commissioner*, 14 T. C. 90, now pending on review in the Third Circuit. The majority of the Tax Court there had held, in effect, that as long as the taxpayer was a partner when the fees were received by the partnership—regardless of whether he had been a



partner for 36 months or not—he was entitled to the benefit of Section 107 (a), and he was entitled to allocate his share of the fees over the entire period of the rendition of the services by the partnership. The Tax Court majority in the *Marshall* case, while agreeing that the Commissioner's position was correct under the statute as originally enacted and while recognizing that it had been so held in the *Lindstrom* case, had erroneously concluded that after the 1942 amendment of the statute the result contended for by the Commissioner was no longer required and treated the *Lindstrom* holding as inapplicable. That conclusion is clearly inconsistent with the purpose expressed by Congress in adopting the 1942 amendment. There is clearly no indication that, in changing the wording of the statutory provision in 1942, Congress intended anything more, in this respect, than a clarification of the provision so as to make it certain that each partner in a partnership would be eligible for Section 107 benefits regardless of whether he personally performed or participated in the services for which the long-term fee is received by the partnership.

In addition, the conclusion of the Tax Court majority in the *Marshall* case, followed in this case, is clearly contrary to the basic purpose of the statute to grant relief from the hardship falling on persons “who work for long periods of time without pay” and then receive their compensation all at one time. Before he became a partner on August 1, 1943, the taxpayer was being paid currently for his services and therefore was not one of the persons to whom Congress intended to grant relief from the hardship



resulting upon their getting paid all at one time for long-term services.

#### ARGUMENT

**An incoming partner may not, for the purpose of qualifying for the privilege of spreading income back over years prior to the year of its receipt under Section 107 (a) of the Internal Revenue Code, tack on to his period of membership in the partnership the period of services rendered by the partnership prior to his becoming a member**

This case presents a pure question of law, arising under Section 107 (a) of the Internal Revenue Code, *supra*. Section 107 (a), as amended by Section 139 of the Revenue Act of 1942 and as applicable to the taxable years here involved, provides, in substance, that if at least 80 per cent of the total compensation for personal services covering a period of 36 months or more is received by an individual or a partnership in one taxable year, the tax attributable to any part of that compensation which is included in the income of any individual shall not be greater than the aggregate of the taxes which would have been attributable to that part if it had been included in income ratably over that part of the period of the services which precedes the date of the receipt of the compensation.

In this case, there was no controversy with respect to the requirements of Section 107 (a) relative to the percentage of the compensation or to the length of the services themselves: the stipulated facts demonstrate (R. 26) that, as to all of the fees for long-term services in question received by the partnership, the amount of compensation received constituted in each case at least 80 per cent of the total compensa-

tion for the particular services, and that each of the respective services was rendered over a period exceeding 36 months. The taxpayer did not become a partner until August 1, 1943 (R. 25), which is less than 36 months before the receipt of the fees for the long-term services in question by the partnership in 1944 and 1945, and the only issue in the case, as the Tax Court put it (R. 71), was as to whether the taxpayer was entitled to apply Section 107 (a) so as to include in the time of the rendition of the services the period of services prior to his admission to the partnership—or, stated differently, whether an incoming partner may tack on to his period of membership in the partnership the period during which services were rendered by the partnership prior to his admission to the partnership.

The taxpayer, in his returns and before the Tax Court, claimed the right to compute his tax liability for the taxable years here involved under Section 107 (a) of the Code by allocating his share of the fees for long-term services received during 1944 and 1945, by the partnership of which he was then a member, over the entire period of the rendition of the respective services in question, going back in one instance as early as 1931, in spite of the fact that he did not become a member of the partnership until August 1, 1943. (R. 25, 26, 28, 29, 74.) The position taken by the Commissioner, in his determination of the deficiencies and before the Tax Court, was that with respect to the fees for long-term services received by the partnership in 1944 and 1945 the taxpayer was not entitled to allocate any portion of his

share to any prior taxable year at all, because he had not been a partner for 36 months or more at the time of their receipt. (R. 15-19, 71, 74-75.)

The Tax Court, in deciding this case in favor of the taxpayer, followed its decision in *Marshall v. Commissioner*, 14 T. C. 90, now pending before the Court of Appeals for the Third Circuit on petitions for review by the Commissioner. The issue in the *Marshall* case was whether, as to fees received by the partnership in 1942 and 1943 when the taxpayer there had been a member of the partnership less than 36 months, the taxpayer there could allocate any part of his share of those fees to any prior year under Section 107 (a), and, further, as to fees received by the partnership in 1945 after he had been a partner for more than 36 months, whether he could allocate any part of his share to years prior to his admission to the partnership.

In deciding the *Marshall* case in favor of the taxpayer, the Tax Court, in the majority opinion (14 T. C. 91-95), held in effect that as long as the taxpayer was a partner at the time the fees were received by the firm, he was entitled to the benefit of Section 107 (a), regardless of the fact that at the time of the receipt of some of the fees he had been a partner for less than 36 months, and further, that he was entitled to allocate his share of the fees over the entire period of the rendition of the services since, in the view of the Tax Court majority, it is the status of the recipient of the income in the year of receipt which governs the application of Section 107 in its present form, after the 1942 amendment. The conclusion of



the Tax Court majority in the *Marshall* case, followed in this case, is erroneous, we submit, and it is clearly contrary to the decision of this Court in *Lindstrom v. Commissioner*, 149 F. 2d 344.

In the *Lindstrom* case, a partner who, at the time of the receipt by a partnership of a fee for long-term services, had been a member of the partnership for 45 months, or for less than the minimum period of services prescribed by Section 107 before the 1942 amendment,<sup>7</sup> claimed that he was entitled to the benefit of Section 107 solely because "he received the fee in question 'as a member of a partnership' " (p. 346), or, in effect, because he was a member of the partnership when the fee was received—in substance, the same claim as that made by the taxpayer in this case and in the *Marshall* case. This Court rejected that claim, holding in effect that a partner, to meet the period of service requirement in order to qualify for the benefit of Section 107, could not tack on to the period during which he rendered services that period during

---

<sup>7</sup> Prior to that amendment, Section 107, as originally added to the Code by Section 220 of the Revenue Act of 1939, c. 247, 53 Stat. 862, provided as follows:

In the case of compensation (a) received, for personal services rendered by an individual in his individual capacity, or as a member of a partnership, and covering a period of five calendar years or more from the beginning to the completion of such services, (b) paid (or not less than 95 per centum of which is paid) only on completion of such services, and (c) required to be included in gross income of such individual for any taxable year beginning after December 31, 1938, the tax attributable to such compensation shall not be greater than the aggregate of the taxes attributable to such compensation had it been received in equal portions in each of the years included in such period.



which his partner had rendered services as an individual prior to the formation of the partnership. The Tax Court, in the majority opinion in the *Marshall* case, recognized (p. 92) that the Commissioner's position concededly "was the only tenable one" under Section 107 prior to the 1942 amendment, and further recognized that it had been in fact so held in the *Lindstrom* case, but it concluded that after the 1942 amendment the results contended for by the Commissioner were no longer "required" (p. 94), and hence it treated the holding of the *Lindstrom* case as inapplicable.

As originally added to the Code, Section 107 had provided that as to compensation "received, for personal services rendered by an individual in his individual capacity, or as a member of a partnership," if the specified period of service and percentage of payment are satisfied, then "the tax attributable to such compensation" is to be computed on the Section 107 formula—i. e., the tax shall not be greater than the aggregate of taxes on such compensation would have been had it been received in equal portions during each of the years of the rendition of the services. After the 1942 amendment, the language was changed so as to read that if "compensation for personal services \* \* \* is received or accrued \* \* \* by an individual or a partnership," in the required percentage and for services covering the specified period, then "the tax attributable to any part thereof which is included in the gross income of any individual" is to be computed on the Section 107 formula. The majority of the Tax Court in the *Marshall* case

stated that the amendment reversed the emphasis "from the person who renders the services to the person who is required to report the income" (p. 93), and went on to conclude (pp. 93-95) that the elimination of the requirement of actual participation in the services had the effect of giving the taxpayer, upon the facts of that case, the right to use the Section 107 computation as to all of the long-term fees and to allocate his share of the fees over the entire period of the services.

It is submitted that the holding of the *Lindstrom* case, *supra*, is applicable even after the 1942 amendment of Section 107 and is controlling here. See G. C. M. 25795, 1948-2 Cum. Bull. 61. In taking the opposite view, the majority of the Tax Court in the *Marshall* case pointed (p. 92) to the observation made by this Court, in affirming the *Lindstrom* case, to the effect that the 1942 amendment did not apply to that (the *Lindstrom*) case. We do not believe, however, that that observation by this Court signifies what the majority of the Tax Court in the *Marshall* case seems to suggest, namely, that this Court would have reached a different conclusion, if the 1942 amendment had been applicable, on the particular point before it as to whether the taxpayer there was entitled to Section 107 treatment simply because he received the portion of the fees in question as a member of a partnership even though his period of service as a partner was not sufficient to meet the five year requirement originally specified by Section 107. In view of the fact that the 1942 amendment reduced the minimum period of service to 36 months, it seems more reasonable to

regard the observation made by this Court as one aimed at the change in the minimum period (instead of at the changed wording of the section) because if the 1942 amendment had been applicable there would have been no controversy, since the taxpayer there would have qualified under Section 107 because of his 45 month period as a partner.

Although the taxpayer's claim for the benefits of Section 107 (a) in this case, and in the *Marshall* case, may be "within a permissible interpretation" (14 T. C. at p. 93) of the language of the statute after the 1942 amendment, we submit that it is not within what Congress actually intended—it is not within the intent expressed by Congress in making the particular change in the wording of Section 107 above referred to.

In the Revenue Bill of 1942 (H. R. No. 7378, 77th Cong., 2d Sess.), the House Ways and Means Committee recommended changes in Section 107 with respect to the taxing of compensation for long-term services so as to reduce the period of service from five years to 36 months and the percentage of payment from 95 to 80, and also added a new provision to cover authors, composers and inventors. H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 90–91 (1942–2 Cum. Bull. 372, 441). In the bill as passed by the House, the pre-existing provision of Section 107 became Section 107 (a), and the same wording was retained, except for the change with respect to the length of period and percentage of payment. See 88 Cong. Record, Part 6, p. 7810. The Senate Finance Committee revised the wording of Section 107 (a) so as to read as



finally enacted into law (*supra*), and in its report made the following explanation (S. Rep. No. 1631, 77th Cong., 2d Sess., p. 109 (1942-2 Cum. Bull. 504, 586)):

In order for section 107 (a) to be applicable, it is not necessary that the individual who includes in his gross income compensation for such personal services be the person who renders such services. For example, a partner who shares in compensation for such personal services rendered by the partnership may be entitled to the benefits of section 107 (a), notwithstanding that he took no part in the rendering of such services. Likewise, in community property States, the spouse of a person who renders such personal services may be entitled to the benefits of section 107 (a).

Thus, in so far as stated by Congress, its purpose in the change of the language seems to have been limited to a desire to enable a partner to obtain the benefits of Section 107 as to compensation received by him for "services rendered by the partnership \* \* \* notwithstanding that he took no part in the rendering of such services," and also to enable spouses of persons performing long-term services to take the benefits of Section 107 in community property states. As originally enacted in 1939, the wording of Section 107 was such that it could have been construed so as to deny relief to a partner who did not personally participate in rendering the services with respect to which the fee was received by the partnership. There is no indication that, in changing the language of Section 107, Congress (aside from enabling spouses



in community property states to take the benefit of Section 107) had in mind anything other than clarifying the statutory provision so as to avoid the result which would have been possible under the original wording and so as to make it certain that each individual partner in a partnership would be eligible for the benefits of Section 107 regardless of whether he personally participated in the work which brought in the long-term fees. See H. Rep. No. 2333, *supra*; S. Rep. No. 1631, *supra*, pp. 48-49, 108-110 (1942-2 Cum. Bull. 504, 544, 585-587); H. Conference Rep. No. 2586, 77th Cong., 2d Sess., p. 42 (1942-2 Cum. Bull. 701, 706-707). The elimination of the requirement of actual participation in the services, to which the majority opinion of the Tax Court in the *Marshall* case pointed (p. 94), was, in so far as the expressed intent of Congress goes, intended only to eliminate the requirement, which Section 107 as originally enacted might have been regarded as containing, that any member of a partnership claiming the benefits of Section 107 must establish that he personally performed or participated in the services on the particular matter with respect to which the long-term fee is received. In other words, at least in so far as expressed, the Congressional will was to clarify the provision so as to grant the Section 107 treatment to a partner of the firm which performed services over the required period, and received the required percentage of compensation in a single taxable year, regardless of whether the particular partner personally participated in the particular services.

In addition to being out of harmony with the purpose expressed by Congress in making the 1942 amendment to Section 107, the conclusion of the majority of the Tax Court in the *Marshall* case is contrary to the basic purpose of Section 107. When Section 107 was originally added to the Code by the Revenue Act of 1939, its purpose was stated to be to grant relief from the "hardship" falling upon persons "who work for long periods of time without pay" and then receive their compensation in a lump sum all in one year. S. Rep. No. 648, 76th Cong., 1st Sess., p. 7 (1939-2 Cum. Bull. 524, 528-529). There is no indication whatsoever that Congress, in amending the law in 1942, intended in any way to depart from that basic purpose.

The relief which Congress granted from the hardship falling on those persons "who work for long periods of time without pay" and then are paid all at one time, was to allow them to pay no more tax in the year of receipt of their long-term pay than they would have paid if they had received their compensation ratably over the period of the services. In other words, Congress wanted to place them in the same position, for income tax purposes, that they would have been in if they had received their compensation currently over the years and had paid income taxes thereon each year. Looking at the basic purpose of Section 107, it is clear that the taxpayer, in so far as he shared in fees collected by the partnership during the taxable years relative to services performed prior to the time he became a partner, is not one of the persons to whom Congress

intended to grant relief. Before he became a partner on August 1, 1943, the taxpayer was not a person working "for long periods of time without pay" who later was paid all at one time. For all of the years prior to August 1, 1943, the taxpayer was being paid currently for his personal services. What he received during the taxable years, 1944 and 1945, as his share of the income of the partnership constituted his compensation for personal services during each of *those* years, respectively. In so far as what he received also included a portion of fees collected by the partnership for services which the partnership had performed prior to the time the taxpayer became a partner, that to him was income in the nature of "windfall" income: that was not, to the taxpayer, income received all at one time for services performed "for long periods of time without pay," as to which Congress intended to grant relief from the resulting hardship tax-wise.

Clearly, the conclusion of the Tax Court majority in the *Marshall* case, adopted by the Tax Court in this case, is contrary to the basic purpose of the statute and is erroneous. In this case, the Tax Court in its memorandum opinion stated (R. 75-76) that this case on its facts is even stronger in favor of the taxpayer than the *Marshall* case, because in this case "the taxpayer rendered services over a period of several years" for which the long term fees were received by the partnership in 1944 and 1945,<sup>8</sup> and

---

<sup>8</sup> The taxpayer's participation, prior to his admission to the partnership, in the long term services for which the fees in question were received, was limited, as the stipulation shows (par. 11,



also because the taxpayer here was associated with the firm throughout the entire period over which he seeks to allocate the income in question. These factual differences do not make the taxpayer's position in this case less contrary to the basic purpose of Section 107 than that of the taxpayer in the *Marshall* case: it is still true in this case, as in the *Marshall* case, that until the taxpayer was admitted to the partnership he was being compensated currently for his services and therefore was not a person who worked "for long periods of time without pay" and then received his compensation all at one time, the hardship of which was intended to be relieved by Section 107.

Nor is a different result required in this case by reason of the fact that for part of the time before being admitted to partnership the taxpayer was an employee paid on a profit sharing basis, receiving a guaranteed minimum salary and above that a percentage of net profits, between January 1, 1940, and August 1, 1943. (R. 24-25, 35-44, 72-73.) Nor can that fact entitle the taxpayer to tack his profit sharing period on to his partnership period, so as to give him the qualifying minimum of 36 months or more and thus entitle him to the benefits of Section 107 to the extent of an allocation over that combined period (for a partial allocation back, as the Commissioner permitted in the *Marshall* case with respect to

---

R. 26), to his being "one of the attorneys performing the services" from January 1940 to January 1944 in only one case or legal matter, identified in the stipulation only as one on which "one of the largest" of the long term fees was received in 1944.



the fees there received in the year 1945). Even during the profit sharing period, as before, what the taxpayer received was his full compensation for all his personal services during each year. Although, in addition to his guaranteed salary, he had the right to share in profits up to his specified percentage during the profit sharing period, his right to share therein was limited to fees currently collected by the firm during that period. (See stip. par. 12, R. 26-27.) He was not in any sense a partner (see California Corporation Code, Section 15007 (4) (b) (formerly Civil Code Section 2401); and see also *O. Krenz C. & B. Wks., Inc. v. England*, 109 Cal. App. 747, 293 Pac. 689; *Sievert v. Simonds*, 89 Cal. App. 2d 34, 200 P. 2d 95; *Lyden v. Spohn-Patrick Co.*, 155 Cal. 177, 100 Pac. 236; *Coward v. Clanton*, 122 Cal. 451, 55 Pac. 147; *Black v. Brundige*, 125 Cal. App. 641, 13 Pac. 999) and acquired no proprietary right to fees accruing to the partnership but not collected. What he received as a profit sharing employee was expressly stated in the agreements (Joint Exhibits 1-A through 4-D, R. 35-44) as being paid to the participants "by way of compensation only and not as parties to a joint business venture", and the agreements further provided that "the participating privilege does not constitute participants partners" (R. 36, 38-39, 40, 41, 43).

It may be pointed out in passing that we do not believe any significance ~~out~~ to be accorded, as the Tax Court majority in the *Marshall* case seems to have done (p. 93), to the fact that the arrangement, whereby the partners permitted the taxpayer there to share

in fees received by the partnership after his admission to the partnership for work performed prior thereto, may well have been "an obviously arm's length business transaction" and may well have had "a business purpose." That the other partners were willing to give the taxpayer that benefit, is immaterial: what the taxpayer in that case received during each of the years 1942, 1943 and 1945 was as to him compensation for his services during each of those years, respectively, as pointed out in the dissenting opinion (pp. 96-97), even though measured in part by an amount equal to a percentage of fees for legal services performed by the partnership prior to the taxpayer's admission thereto. The same applies to what the taxpayer in this case received during the taxable years 1944 and 1945: it was compensation for his services during *those* years. Before becoming a partner, while working as an employee of the firm, the taxpayer had been paid for his services currently, and therefore was not working "for long periods of time without pay" so as to qualify for the relief which Congress intended to grant by Section 107.

While the purpose of Section 107 (a), to alleviate the hardships falling on those who receive all at one time compensation for services of long duration, should not be defeated by too strict an interpretation, nevertheless the statute should not be extended beyond the expressed will of Congress. This is particularly true in the case of a provision constituting an exception to the fundamental principle governing the taxation of income upon the basis of annual periods and annual accountings (*Burnet v. Sanford & Brooks Co.*,

282 U. S. 359; *Heiner v. Mellon*, 304 U. S. 271; *Security Mills Co. v. Commissioner*, 321 U. S. 281), such as Section 107 (a). *Lindstrom v. Commissioner*, 149 F. 2d 344, 346.

To be entitled to the special tax treatment accorded by Section 107, a taxpayer should be required to bring himself within the letter and the spirit of the Congressional grant. *Lindstrom v. Commissioner*, *supra*, p. 346. *Helvering v. Northwest Steel Mills*, 311 U. S. 46. In the *Lindstrom* case this Court, viewing Section 107 as akin to a special exemption provision, observed that such provisions are "to be strictly construed" (p. 346). See *Sovick v. Shaughnessy*, 92 F. Supp. 202, 205 (N. D. N. Y.); cf. *Slough v. Commissioner*, 147 F. 2d 836 (C. A. 6th). In speaking of Section 107, the Court of Appeals in *Smart v. Commissioner*, 152 F. 2d 333, 335 (C. A. 2d), certiorari denied, 327 U. S. 804, stated that "the section is an exemption and as such must submit to close scrutiny; and—what is more important—Congress has been sparing in the relief given." After noting the provisions of Section 107 in its original form and the changes made by the 1942 amendment, the Court of Appeals further observed that it was not permitted "any assumption that it [Section 107] is infused with a broad purpose, which we should ramify as the occasion may demand." (P. 335.)

While the taxpayer's position may be "within a permissible interpretation" (14 T. C. at p. 93) of the language of the statute as amended in 1942, it is not within the intent expressed by Congress, as we have shown, and to sustain it would lead to absurd and



unreasonable consequences. Under the holding of the majority of the Tax Court in the *Marshall* case, followed in this case, if an individual be a member of a partnership—even though for only one day—at the time it receives a fee for services rendered over a period of say 20 years, he would be entitled to the benefit of Section 107 (a) with respect to his distributable share, and would be allowed to allocate his share over the 20-year period of the services. If such an unreasonable result, so clearly at variance with the basic purpose of Section 107, be permitted by the literal words of the statute, then the purpose—rather than the literal words—should be followed. *United States v. Amer. Trucking Ass'ns*, 310 U. S. 534, 543.

Another aspect of this question might be commented upon briefly before closing. In the majority opinion of the Tax Court in the *Marshall* case, it is stated that the Commissioner “apparently accepts the further proposition that the accession of petitioner [taxpayer] to the partnership did not bring about a dissolution of the old firm nor create a new one \* \* \* so that it can not successfully be contended that the services were not rendered by the partnership of which petitioner became a member.” (14 T. C. at p. 93.) That statement demonstrates that the conclusion of the majority of the Tax Court in the *Marshall* case implicitly rests on the assumption that the long-term services there in question, covering the years 1932 to 1945, were performed by a single separate entity. That assumption is erroneous: the law firm, whether viewed as the same continuing partnership or as a series of successive partnerships coming into exist-



ence on each change in membership, was not an entity separate and apart from its members. See Internal Revenue Code, Sections 181 to 190; *Randolph Products Co. v. Manning*, 176 F. 2d 190 (C. A. 3d); *Commissioner v. Whitney*, 169 F. 2d 562 (C. A. 2d), certiorari denied, 335 U. S. 892; *Helvering v. Smith*, 90 F. 2d 590 (C. A. 2d); G. C. M. 25795, 1948-2 Cum. Bull. 61. This fundamental principle, that for tax purposes a partnership does not exist as an entity separate and apart from the partners, was properly recognized in the dissenting opinion of Judge Hill in the *Marshall* case. (Pp. 95-96.) As correctly pointed out in that dissenting opinion (p. 96), the long-term services in that case were rendered not by the taxpayer individually but in part (before January 1, 1941) by a group of individuals or a partnership of which the taxpayer was not a member, and in part (after January 1, 1941) by a group of individuals or a partnership of which the taxpayer was a member. And that dissenting opinion, we submit, expresses (p. 96) the correct conclusion in that case, namely, that the partnership services rendered prior to January 1, 1941, are not attributable to the taxpayer or available to him for the application of Section 107 (a) because he was not a member of the partnership which rendered those services. And the same is true in this case: the partnership services rendered prior to August 1, 1943, are not attributable to this taxpayer or available to him for the application of Section 107 (a) because he was not a member of the partnership which rendered them. The partnership services rendered prior to August 1, 1943, can no more be

availed of by the taxpayer for the application of Section 107 (a) than could services rendered before that date by some other individual lawyer who on that date had formed a partnership with the taxpayer. Cf. *Lindstrom v. Commissioner, supra*.

#### CONCLUSION

For the foregoing reasons, it is submitted that the decisions of the Tax Court in these cases should be reversed, and the determinations of the Commissioner reinstated.

Respectfully submitted,

THERON LAMAR CAUDLE,  
*Assistant Attorney General.*

ELLIS N. SLACK,

HARRY MARSELLI,

*Special Assistants to the Attorney General.*

NOVEMBER, 1950.

No. 12,610

IN THE  
United States  
Court of Appeals

For the Ninth Circuit

---

COMMISSIONER OF INTERNAL REVENUE,  
*Petitioner,*

vs.

BURNHAM ENERSEN AND NINA W. ENERSEN,  
*Respondents.*

---

Brief for Respondents

---

HENRY D. COSTIGAN  
STANLEY MORRISON  
GORDON M. WEBER  
1500 Balfour Building  
San Francisco 4, California

*Attorneys for Respondents.*

McCUTCHEN, THOMAS, MATTHEW,  
GRIFFITHS & GREENE

1500 Balfour Building  
San Francisco 4, California

*Of Counsel*

FILED

DEC - 7 1950

PAUL P. O'BRIEN,

CLERK





## TABLE OF CONTENTS

	Page
Introductory Statement.....	1
Statement of Pleadings and Facts Disclosing Jurisdiction.....	2
Statement of Facts.....	2
Statutory Provisions.....	5
Summary of Argument.....	6
Argument .....	9
I. By the Express Terms of Section 107(a) Its Benefits Are Available to Any Person Who Is Required to Include in His Gross Income Any Part of Compensation of the Type Described in the Section, Regardless of His Prior Connection with the Partnership.....	9
A. This Is Demonstrated by the Precise Language of Section 107(a) Which Is Unambiguous and Leaves No Room for Construction .....	9
B. That Section 107(a) Means What It Says Is Further Demonstrated by the Legislative History.....	17
C. The Decision of This Court in Lindstrom v. Commissioner, 149 F.2d 344, Gives No Support to the Commissioner's Position .....	25
D. Taxpayer and His Wife May Not Be Deprived of the Benefits of Section 107(a) on the Theory That a New Partnership Was Formed When Taxpayer Became a Member.....	27
II. Taxpayer and His Wife Are Entitled to Compute Their Taxes Under Section 107(a) Because of His Right for More Than Thirty-Six Months Prior to Receipt of Each Fee to Share in the Partnership Profits.....	31
Conclusion .....	34
Appendix.	

## TABLE OF AUTHORITIES CITED

CASES	Pages
Callahan v. War Contracts Price Adjustment Board (1949), 13 T.C. 355 .....	31
Cameron v. Commissioner (C.C.A. 3, 1932), 56 F.2d 1021.....	31
Commissioner v. Korell (1950), 339 U.S. 619.....	15
Commissioner v. Lehman (C.A. 2, 1948), 165 F.2d 383.....	30
Commissioner v. Mnookin's Estate (C.A. 8, 1950), 184 F.2d 89.....	30
Commissioner v. Shoong (C.A. 9, 1949), 177 F.2d 131.....	16
Ford (1946), 6 T.C. 499.....	31
Girard Trust Co. v. United States (C.A. 3, 1950), 182 F.2d 921.....	30
Lindstrom v. Commissioner (C.C.A. 9, 1945), 149 F.2d 344.....	8, 25, 26
Lucas v. Earl (1930), 281 U.S. 111.....	24
Marshall (1950), 14 T.C. 90.....	13, 17, 26, 32
Sanford, Estate of, v. Commissioner (1939), 308 U.S. 39.....	27
Shoong v. Commissioner (1950), 334 U.S. 974.....	16
Waldman, Estate of Isidore (1950), 15 T.C. No. 80.....	31
White v. Long (1927), 289 Pa. 525, 137 Atl. 673.....	30

## STATUTES

California Corporations Code, Sec. 15017.....	29
California Corporations Code, Sec. 15027.....	30
Internal Revenue Code, Sec. 107.....	5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 17, 18, 19, 20, 21, 22, 23, 24, 25, 27, 28, 29, 31, 32, 34, 35
Internal Revenue Code, Sec. 117.....	14
Internal Revenue Code, Sec. 125.....	15
Revenue Act of 1939, Sec. 220.....	5, 18, 19
Revenue Act of 1942, Sec. 139.....	5, 18, 19
Revenue Act of 1950, Sec. 217.....	16
Uniform Partnership Act, Sec. 17.....	29
Uniform Partnership Act, Sec. 27.....	30
Uniform Partnership Act, Sec. 29.....	30
Uniform Partnership Act, Sec. 30.....	30

# TABLE OF AUTHORITIES CITED

iii

## REGULATIONS AND RULINGS

Pages

G.C.M. 25,795, 1948—2 Cum. Bul. 61.....	27
Regulations 103, Sec. 19.107-2.....	13
Regulations 111, Sec. 29.107-1.....	13, 20

## MISCELLANEOUS

Senate Report No. 648, 76th Congress, 1st Session.....	22
Senate Report No. 1631, 77th Congress, 2nd Session.....	20, 21





No. 12,610

IN THE

**United States  
Court of Appeals**

**For the Ninth Circuit**

---

---

COMMISSIONER OF INTERNAL REVENUE,	}
<i>Petitioner,</i>	

vs.

BURNHAM ENERSEN AND NINA W. ENERSEN,	}
<i>Respondents.</i>	

---

**Brief for Respondents**

---

**INTRODUCTORY STATEMENT**

These are petitions filed by the Commissioner of Internal Revenue to review two decisions of the Tax Court of the United States. The taxpayers, respondents herein, are husband and wife, Burnham Enersen and Nina W. Enersen. The sole issue involved is whether the husband was entitled to the benefits of Section 107(a) of the Internal Revenue Code in computing his income tax for 1944 and 1945 upon his distributive shares of certain fees received by the law firm of which he was then and is now a partner. The wife is involved because the said fees

were community property and hence reportable for income-tax purposes half in the husband's return and half in the wife's return (Commissioner's brief, p. 7). It is not disputed that if the husband is entitled to the benefits of Section 107 upon his return, his wife is likewise entitled to the benefits of said Section with respect to the half of the said fees reported in her return.

Accordingly, the two cases involve the same issue and the same material facts. For this reason they were consolidated for hearing and opinion in the Tax Court and the petitions for review are presented to this Court on a single record. For convenience the husband, Burnham Enersen, will be referred to herein as the "Taxpayer" and the wife, Nina W. Enersen, will be referred to as "Taxpayer's wife." We shall discuss only the case of Taxpayer, the husband, except where the wife's situation has particular significance in the argument.

It is also to be noted at the outset that the Commissioner does not question the computations of their taxes made by Taxpayer and Taxpayer's wife in their returns, if Section 107 is applicable, but only questions the applicability of the Section (Commissioner's Brief, p. 7 and especially footnote 6, pp. 7-8). Therefore, if Section 107 is held applicable, the Tax Court decisions that there are no tax deficiencies (R. 77-78) may be affirmed without any need for recomputations.

### **STATEMENT OF PLEADINGS AND FACTS DISCLOSING JURISDICTION**

We accept the statement on this subject under the heading "JURISDICTION" in the Commissioner's Brief, pages 1-2.

### **STATEMENT OF FACTS**

The facts are not in controversy, having been agreed to by the parties in the Stipulation of Facts (R. 23-31) and the Joint Exhibits 1-A, 2-B, 3-C and 4-D (R. 35-44) incorporated by refer-

ence in Paragraph (7) of the Stipulation (R. 24-5). The Tax Court made findings of fact in which it first found the facts as stipulated (R. 72, first paragraph) and then summarized them in more general form (R. 72-4).

Except for one inaccuracy and one omission, we are satisfied with the Statement of Facts set forth in the Commissioner's Brief under the heading "STATEMENT" at pages 4-8.

The inaccuracy referred to occurs in the description, on page 5 of the Commissioner's Brief, of the agreements about Taxpayer's compensation as employee of the partnership for the period from January 1, 1940, to August 1, 1943. The brief there states:

"... Under these agreements, a minimum salary was guaranteed, and above the guaranteed amount a percentage of net profits was paid. During the years 1940, 1941, 1942, and 1943, up to August first, the taxpayer received the guaranteed salary, plus a percentage of profits at the end of each year. (R. 72-73)"

This passage has the justification of being quoted verbatim from the fourth paragraph of the Tax Court's Findings of Fact (R. 72-3, including the correction of the fourth line from the bottom on R. 72, which was garbled by the printer). However, the underlying stipulated facts, and particularly the written agreements themselves, which were stipulated as Joint Exhibits, are somewhat different and we take it that their terms—which were specifically found as facts in the Tax Court's finding that the facts were as stipulated (R. 72)—will be controlling as against the more general summary of their terms given by the Tax Court Judge. Examination of paragraph 7 of the Stipulation (R. 24-5) and of the Joint Exhibits therein referred to and which also appear in the Record (R. 35-44) shows that instead of being compensated by a salary *plus* a percentage of net profits during this period, Taxpayer was compensated by a share of net profits which, however, was guaranteed to be not less than a minimum annual amount—such minimum amount being paid monthly during the



year and any excess of the percentage of profits over such minimum amount being paid at the end of the year. In this connection, it is also to be noted that during each year of the period the Taxpayer's percentage of the net profits exceeded the minimum annual amount, so that his entire compensation for each such year actually became the specified percentage of net profits (Stip. 7, R. 24-5). The significance of this is, of course, that if the legal fees involved in this case had been received by the partnership ratably over the period during which the services were performed, Taxpayer would necessarily have received his percentage of portions thereof as additional compensation in the earlier years, 1940-43, rather than having it "bunched" into the taxable years 1944-5 here involved.

The omission from the Statement of Facts in the Commissioner's Brief, which we believe should be corrected because of its possible importance in the argument, consists of the description of the manner in which the partnership in question treated fees received by it. This description should be inserted in the Statement of Facts in the Commissioner's Brief on page 6 as follows:

"With certain exceptions not here relevant, all fees and compensation received by the partnership are pooled in a single fund and, after payment of expenses, are divided among those partners and those employees on a profit-sharing basis who had such status at the time of receipt of such fees and compensation, in accordance with their percentages in the month of receipt (Stip. 12, R. 26-7). [Under this arrangement, of course, such persons need not have been entitled to share during the whole prior period of performance of the services for which any such fee is paid.] Conversely, persons who have had a status of partner or profit-sharing employee during part of the period of performance of the services for which the fee is received, but who did not have such status during the month of the receipt of such fee (e.g., partners or employees who retire before



such receipt) do not share in the fee (Stip. 12, R. 27). The procedure outlined in this paragraph was followed at all times involved in these cases (Stip. 13, R. 27). Each of the fees involved in these cases [and referred to in the long paragraph on pages 6-7 of the Commissioner's Brief] was handled in accordance with this procedure (Stip. 14, R. 27.)"

### STATUTORY PROVISIONS

The statute which governs the disposition of these cases is Section 107(a) of the Internal Revenue Code as amended by Section 139(a) of the Revenue Act of 1942:

"(a) PERSONAL SERVICES.—If at least 80 per centum of the total compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual."

Relevant to the interpretation of this statute is the wording of the only prior version of Section 107(a) of the Code, as originally enacted by Section 220(a) of the Revenue Act of 1939:

"In the case of compensation (a) received, for personal services rendered by an individual in his individual capacity, or as a member of a partnership, and covering a period of five calendar years or more from the beginning to the completion of such services, (b) paid (or not less than 95 per centum of which is paid) only on completion of such services, and (c) required to be included in gross income of such individual for any taxable year beginning after December 31, 1938, the tax attributable to such compensation shall not be greater than the aggregate of the taxes attributable to such compensation had it been received in equal portions in each of the years included in such period."

**SUMMARY OF ARGUMENT**

The sole issues involved in this case relate to the interpretation of Section 107(a) of the Internal Revenue Code as applied to the facts presented. It is undisputed that all the requisites expressly set forth in that section have been fully met. The question raised by the Commissioner is whether there should be read into the statute by implication the additional requirement that Taxpayer must have been a member of the partnership for more than 36 months before receipt of the income in question.

Examination of the text of Section 107(a), as well as of its legislative history, makes it clear that Congress gave careful consideration to the legislative policy embodied in the section and to the drafting of its language. Congress laid down in unmistakable terms what the requisites are upon which the application of the section depends. The statute is unambiguous and leaves no room for construction.

The general purpose of Section 107(a) is to alleviate the tax burden which results from the receipt in one year of compensation for services rendered over a period of years. The method of relief is to limit the tax attributable to such compensation to the aggregate of the taxes which would have been imposed if the compensation had been received ratably over the period during which the compensation was rendered.

The only question is what the conditions are upon which the application of the section depends. The conditions specified by Congress are (1) that there must be compensation for personal services covering a period of 36 calendar months or more, (2) that 80% of such compensation must be received in one taxable year, and (3) that it must be received by an individual or a partnership. When these conditions are met the tax computation benefits of the section apply to "any part" of such compensation which is included in the gross income of "any individual."

In this case the compensation in question was required by law to be included in the gross income of Taxpayer (and of his wife as community property) and the Commissioner so included it. "Any individual" includes Taxpayer. Accordingly, Taxpayer is entitled to the benefits of Section 107(a) under the express mandate of Congress.

What the Commissioner seeks to do is to insert in Section 107(a) after the phrase "any individual" the additional and qualifying phrase "who has been a member of the partnership for at least 36 months before receipt of the compensation by the partnership." The Commissioner seeks to do this under the guise of interpretation. But actually Congress has expressed its intent in language so clear that there is no room for interpretation. Thus the Commissioner is really seeking to amend the statute and is asking this Court to encroach on the constitutional legislative power of Congress.

That Congress means what it has said in Section 107(a) is further demonstrated by the legislative history. As originally enacted in 1939, Section 107 was narrower, and its benefits were limited to the taxpayer who actually performed the services for which the compensation was received. But this restriction was eliminated by the Revenue Act of 1942, which drastically revised Section 107(a). Since 1942 the section applies to "any part" of the compensation which is included in the gross income of "any individual." That it is no longer necessary that the taxpayer benefiting from Section 107(a) shall himself have performed the services is expressly recognized in the Report of the Senate Finance Committee as well as in the Income Tax Regulations. In the case of partnership income the legislative intent is now clear that the section applies to a taxpayer who must report the income and who is a member of the partnership at the time the income is received, even though he has not been a member during the entire period over which the services have been rendered.



The Commissioner relies upon the decision of this Court in *Lindstrom v. Commissioner* (1945), 149 F.2d 344. This case arose under the 1939 version of the law and it was properly held that Section 107(a) did not apply to a partner sharing in compensation for services rendered by another partner prior to the formation of the partnership. But since 1942 it has no longer been necessary that the partner reporting a share of the compensation shall himself have performed the services. Hence the *Lindstrom* case is not in point here and affords no support to the Commissioner's position.

Under Section 107(a) it is immaterial whether technically a new partnership was formed when Taxpayer entered the firm. In any event, under California law, the old partnership continued without the formation of a new one.

Even if this Court should hold that Congress intended to benefit only those individuals who had been themselves entitled to share in the fees for a period of 36 months or more, it is enough that Taxpayer in this case for well over 36 months prior to receipt of the fees in question was entitled to share in the partnership profits, either as a partner or, prior to the date of his admission to the firm, as a profit-sharing employee.

The ultimate issue in this case is a fundamental one. Congress has legislated in terms which leave no room for doubt as to its meaning. The Commissioner disagrees with the legislative policy. He seeks to persuade this Court to amend the Internal Revenue Code. He has come to the wrong forum. He should take his complaint to Congress.



**ARGUMENT****I**

**By the Express Terms of Section 107(a) Its Benefits Are Available to Any Person Who Is Required to Include in His Gross Income Any Part of Compensation of the Type Described in the Section, Regardless of His Prior Connection with the Partnership.**

**A. THIS IS DEMONSTRATED BY THE PRECISE LANGUAGE OF SECTION 107(a) WHICH IS UNAMBIGUOUS AND LEAVES NO ROOM FOR CONSTRUCTION.**

Ordinarily a taxpayer making his returns on the cash basis (as did the present Taxpayer) must include in gross income for the taxable year all income received during that year and it is subjected to tax at the rates applicable to such year. By Section 107(a) Congress has provided an exception with respect to compensation for personal services covering a period of 36 months or more. Where the section applies, the tax attributable to such compensation shall not be greater than the aggregate of the taxes attributable to the compensation in question "had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt."

The sole question raised in this case is whether the Taxpayer is entitled to the benefits of this provision in the computation of the taxes upon Taxpayer's share of the compensation received by the partnership of which he was a member. The question is a narrow and relatively simple one of statutory construction. The language of Section 107(a) is short and explicit. Congress has laid down in carefully drawn and unmistakable terms what the conditions are upon which the application of the section depends. If these conditions are met, the Taxpayer is entitled to its benefits; if the conditions are not met, the Taxpayer may not claim such benefits. These conditions may not be enlarged or diminished by administrative fiat.

It only remains to consider what the conditions are that Congress has laid down. A reading of Section 107(a) makes it evi-

dent that these conditions are the following and only the following:

1. There must be compensation for personal services covering a period of 36 calendar months or more.<sup>1</sup>
2. 80% of such compensation must be received in one taxable year.<sup>2</sup>
3. It must be received by an individual or a partnership.<sup>3</sup>

When the foregoing three conditions are met, then the tax computation benefits of the section apply to "the tax attributable to *any part* [of such compensation] which is included in the gross income of *any individual*."<sup>4</sup> (Emphasis supplied.)

It is obvious from the record that all of the three conditions above listed are fully met in the present case. The Commissioner admits that all three were fulfilled with respect to the fees involved in this case, saying with respect to such fees in his Statement of Facts (Commissioner's Brief, page 6):

"During 1944 and 1945, the partnership received fees from clients representing compensation for personal services which had been rendered by the firm over a period of 36 months or more, the amounts received as fees during

---

<sup>1</sup>"If . . . compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) . . ." (Sec. 107(a)).

<sup>2</sup>"If at least 80 per centum of the total compensation [for the services described in note 1 above] is received or accrued in one taxable year . . ." (Sec. 107(a)). Here the word "received" applies to the cash basis Taxpayer and partnership involved in this case.

<sup>3</sup>". . . by an individual or a partnership, . . ." (Sec. 107(a)).

<sup>4</sup>The preceding three footnotes include all of the words used in the conditional or "if" clause of Section 107(a). The remaining words of the subdivision constitute the predicate or main clause reading as follows: ". . . the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual."

each year on each case or matter constituting at least 80 per cent of the total compensation therefor."

And see the same admission in his argument, Commissioner's Brief, pp. 11-12. Thus compensation complying with all three conditions was received in each of the taxable years by the partnership of which Taxpayer was a member. For convenience, we may call this "qualified" compensation, i.e. qualified for the benefits of Section 107. Taxpayer's agreed percentages thereof—in the amounts stated on page 6 of the Commissioner's Brief—therefore constituted "parts" of such qualified compensation which had to be "included in the gross income of any individual," i.e., the gross income of Taxpayer (and in that of his wife as to her community property half) and could not have been legally included in the gross income of anyone else. Thus Taxpayer's share of the qualified compensation must be given the benefits of Section 107(a) in his (and his wife's) tax returns, or such benefits will be denied completely with respect to this portion of compensation which falls squarely within the scope of the section.

Any such denial would do gross violence to the intent of Congress and to its express language. This language makes it too clear for question that Congress intends Section 107(a) to apply to *all* compensation of the sort described. Not only is this implicit in the whole sub-section but it is expressed in calculated and carefully chosen words which leave no room for doubt or ambiguity. Assuming the receipt of qualified compensation, Section 107(a) extends "to *any part* thereof which is included in the gross income of *any individual*." These are the key words of the section as applied to this case.

"Any part" includes Taxpayer's part of the compensation in question. "Any individual" includes Taxpayer (or his wife as to her half). Nothing could be clearer. If language like this is not respected, legislation becomes a joke. Congress here has left no



doubt as to its meaning and no room for construction either by the Commissioner or the Courts.

Thus what the Commissioner is asking this Court to do is to amend the Internal Revenue Code—not to construe it. It may be noted that he does not go so far as to contend that Section 107(a) applies only where the taxpayer receiving the compensation also performs the services for which the compensation is paid. (See Commissioner's Brief, pp. 18-19). This position would be impossible in view of the revision of Section 107 made by the Revenue Act of 1942. What he does contend is that an incoming partner may not avail himself of Section 107(a), if he has not been a member of the partnership for 36 months or more at the time of receipt of the fees in question.

Apparently the Commissioner believes that Taxpayer is not "any individual" within the key words of Section 107(a). He could scarcely deny that Taxpayer's community property half of his percentage of the qualified partnership compensation constituted "any part thereof which is included in the gross income" of Taxpayer, because he himself included the same in gross income in his deficiency notice in this case (R. 13-20) and, of course, Taxpayer and the Tax Court did likewise in Taxpayer's computation (Stip. 17, R. 28-31) which the Tax Court approved (R. 74-6 and 77), the only difference between their treatment and the Commissioner's being in the computation of the tax attributable to such part and not in the inclusion thereof in gross income.

Therefore the Commissioner is here seeking to have this Court hold that Taxpayer is not "any individual" as that term is used in Section 107(a) despite the broad and unqualified nature of such term. In other words, the Commissioner is asking this Court to treat the key words of Section 107(a) as if they confined the tax computation benefits of the section to "any part" of the qualified compensation received by a partnership "which is included in the gross income of any individual *who has been a member of*



*the partnership for at least 36 months before receipt of the compensation by the partnership.*" The italicized words are not in the section at all, but the Commissioner wants this Court to insert them by "interpretation."

The legislative character of this change which the Commissioner seeks is indicated not only by the above explanation of his "interpretation" as an insertion of specific words into the statute, but also by his admissions regarding the Tax Court's decision in this case and in the leading case which the Tax Court followed in its opinion, namely,

*Marshall* (1950), 14 T.C. 90, C.C.H. Dec. 17,456 (reviewed by Tax Court with dissents by 3 of its 16 judges).

Both at page 17 and at pages 25-6 of the Commissioner's Brief it is admitted that these decisions of the Tax Court and the Taxpayer's position in this case are "within a permissible interpretation" of the language of the statute. If so, why should this Court exercise its appellate power—in a case of agreed facts where the power is intended for the correction of clear errors of law—to change that "permissible interpretation" adopted *en banc* by the Tax Court, the recognized expert interpreter of the Internal Revenue Code? Obviously, the Commissioner's Brief is addressed, not to any appellate power of review, but to the power of Congress to change the "permissible interpretation" by amendment.

The legislative character of the change sought by the Commissioner is additionally indicated by its special nature. He concedes that under Section 107(a) it is not necessary that a taxpayer receiving its benefits must himself have performed the services for which the compensation is paid.<sup>1</sup> And there are various

---

<sup>1</sup>This concession is necessitated by the express regulation that a partner who shares in the compensation need not have performed any of the services in order to obtain the benefits of Section 107(a), as contained in the Commissioner's Regulations 111, Section 29.107-1, 3rd subparagraph, now in effect, and the corresponding 3rd subparagraph of the prior Regulations 103, Section 19.107-2, as added by Treasury Decision 5220, dated February 2, 1943, and effective on that date.

situations in which an individual may share in compensation for services rendered by others. It is common enough for a partner to share in income received by the partnership for services rendered by other partners or employees. What the Commissioner is doing is to take one special case of this sort—i.e., an incoming partner who shares in fees received subsequent to his admission to membership for services rendered prior to his admission—and to write such a taxpayer out of the statute, while leaving other similar cases within the statute. Furthermore, he undertakes to make the position of this class of taxpayers depend upon compliance with a requirement of membership in the partnership for 36 months or more. Congress, however, made no such requirement. The statute is completely silent with respect to any period of membership in the partnership on the part of the individual who is to benefit from the application of Section 107(a), although the Commissioner's Brief seeks to imply that there is a period-of-membership requirement in his very statement of the question at issue at the commencement of his argument on pages 11-12 of the Commissioner's Brief. It is said there (p. 12) that this question is:

"...—or, stated differently, whether an incoming partner may *tack* on to his period of membership in the partnership the period during which services were rendered by the partnership prior to his admission to the partnership." (Emphasis supplied.)

If the statute did require 36 months' membership by the benefiting partner, a question of "tacking" might be involved, as it is, for example, when it is claimed that the periods of two ownerships may be tacked together in determining the holding period for a long-term capital gain under I.R.C. Section 117. But where no membership period is specified in Section 107(a), it is misleading to state that the question of tacking some prior period on to this

Taxpayer's period of membership in the partnership is here involved.

Whether or not the Commissioner's attempt to insert a 36 months' membership requirement into Section 107(a) with respect to partnership compensation would be wise legislative policy is immaterial. The point is that it constitutes a complete break from the actual language of the Code. If such changes are to be made in the statutes, it is the constitutional function of Congress to make them—not that of the Commissioner or the Courts. The Supreme Court has recently reminded us of this in its decision in

*Commissioner v. Korell* (1950), 339 U.S. 619.

This case involved the interpretation of Section 125 of the Internal Revenue Code, establishing the deduction for amortizable "bond premium." The question was whether the benefits of the section applied to bonds purchased at a premium occasioned by their convertibility into common stock. The Supreme Court held first that the term "bond premium" was unambiguous and included a premium based on convertibility as well as one based upon the interest rate of the bond. Having adopted this premise, the Supreme Court concluded that the statutory provision must be enforced as Congress had written it, despite the obviously unfortunate tax consequences in the case before it, where the taxpayer had been able to obtain a deduction for what was obviously not a real loss in value in view of his rights under the conversion feature of the bonds. In the course of its opinion, the Court said (p. 625):

"To be sure, Congress might have proceeded by defining 'premium' (and 'true' premium) rather than, or as well as 'bond.' But we cannot reject the clear and precise avenue of expression actually adopted by the Congress because in a particular case we may know, if the bonds are disposed of prior to our decision, that the public revenues would be maximized by adopting another statutory path. Congress was legislating for the generality of cases."



Before the Supreme Court's pronouncement in the *Korell* case, one could well have disagreed with the premise that the term "bond premium" was unambiguous. This Court itself in the similar case of

*Commissioner v. Shoong* (1949), 177 Fed.2d 131,

held that "bond premium" was a term requiring interpretation and construed it as including only a "true" bond premium based on the interest rate of the bond and as not covering a premium due to a conversion right. However, the *Shoong* case was reversed by the Supreme Court on the authority of the *Korell* case (*Shoong v. Commissioner* (1950), 339 U.S. 974), and thus it must be taken as established law that the term "bond premium" clearly covers any type of premium, including one due to convertibility. Adopting this premise, no one can quarrel with the Supreme Court's conclusion that the only way in which the adverse effect of the term upon the public revenues should be corrected is by amendatory legislation of Congress.<sup>1</sup>

In our case the key phrase "any individual" is completely free from ambiguity; and the Tax Court recognized that "judicial amendment" would be similarly inappropriate. The Court said (R. 76):

"Since it is the status of the recipient of the income in the year of receipt, and not either his status in prior years, Federico Stallforth, 6 T.C. 140, nor the identity of the individual who contributed the services, that is made to govern the application of section 107 in its present form, we are satisfied that under the facts of this proceeding petitioner correctly computed his tax by use of its provisions."

---

<sup>1</sup>It is interesting to note in this connection that the legislative correction of the use of the term "bond premium" in Section 125 followed at once after the Supreme Court decisions in the *Korell* and *Shoong* cases. Section 217 of the Revenue Act of 1950, effective with respect to bonds acquired after June 15, 1950, amends Section 125 to provide that: "In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond."



This decision was in accord with another decision handed down by the Tax Court at approximately the same time. This was the similar leading case already mentioned above,

*Marshall* (1950), 14 T.C. 90, C.C.H. Dec. 17,456.

The present case is stronger for the taxpayer than the *Marshall* case, as the Tax Court pointed out. It said (R. 75-76):

"The facts in this proceeding present an even stronger case for the petitioner than did the facts in the *Marshall* case, because in this proceeding the taxpayer rendered services over a period of several years for which the fees in which he shared, in 1944 and 1945, were paid by clients as compensation for personal services; and, also, he has been associated with the law firm in question throughout the period of years over which he seeks to allocate the income in question."

The Tax Court was clearly correct. If the Commissioner is dissatisfied with Section 107(a) as Congress has written it, he should take his complaint to Congress and not to this Court.

**B. THAT SECTION 107(a) MEANS WHAT IT SAYS IS FURTHER DEMONSTRATED BY THE LEGISLATIVE HISTORY.**

Where the language of a statute is too clear to leave room for doubt as to its meaning, there is no need to resort to legislative history. However, the history of Section 107(a) affords the strongest evidence that Congress did mean what it said and that there is no justification for writing into the statute specific restrictions that Congress did not choose to put there.

Section 107 originated in the Revenue Act of 1939, was amended by the Revenue Act of 1942, and has not since been changed. On page 5 of this Brief, above, we have separately set forth each of its versions: first the present Section 107(a), as amended in 1942,<sup>1</sup> and then the original 1939 version of Sec-

---

<sup>1</sup>Section 107(b) in the 1942 amendment applies to another type of situation and is not here relevant.

tion 107. In addition, a parallel column comparison of the two versions is attached as Appendix A to this brief, in order to show more clearly the many differences between them.

Upon examining the 1939 version it is at once apparent that the benefits of the section then applied only to qualified compensation (i.e., compensation of the required type as to the period of services and the percentage received in one year) which was

“(a) received, for *personal services rendered by an individual* in his individual capacity, or as a member of a partnership . . . and (c) required to be included in gross income of *such individual* . . .” (Emphasis supplied.)

The term “such individual” must refer back to the “individual” by whom the services were rendered within clause (a). Thus under this 1939 version, only the taxpayer who had actually performed the services could benefit, although he was not debarred because he had performed them as a partner rather than an individual. It followed that his other partners, if they did not perform any of the services, could not, apparently, use section 107(a). It made no difference whether such other partners were old members or newly-admitted members of the firm.

In the Revenue Act of 1942 Section 107(a) got a drastic overhauling, as shown graphically by the parallel column comparison in Appendix A. The period was reduced from five years to 36 months. The percentage was reduced from 95 to 80. The requirement that the requisite percentage of the compensation be paid only on completion of the services was eliminated. A new requirement was added that the requisite percentage of compensation be received or accrued in one taxable year. Additional changes of wording were made.

The changes mentioned in the preceding paragraph are not directly material to the present controversy, but they serve to show that in drafting the Revenue Act of 1942 Congress gave section

107(a) thorough consideration and that the whole problem of the scope of the subsection was carefully reviewed. It cannot be contended that the job of revision was done in any haphazard way. The same care was unquestionably devoted to the remaining change made in 1942, which is material to the present controversy.

This change is most significant. Under the 1939 version the compensation had to be received for personal services rendered by an individual (in his individual capacity or as a member of a partnership) and was required to be included in the gross income of *the same individual*. The 1942 Act does not contain this requirement that the services be rendered by the same taxpayer who must report the income. It is now provided that wherever "compensation for personal services . . . is received or accrued . . . by an individual *or a partnership*," the tax computation benefits apply "to *any part* thereof which is included in the gross income of *any individual*." It is plain that performance of the services by the individual reporting the income was thus intentionally eliminated as a requirement.

It is not surprising that Congress should have made this change. In a normal partnership, services may be rendered by any partner or by employees, yet the compensation is payable to the partnership. It is also usual for each partner to receive a percentage of the total income of the firm. Thus normally a substantial portion of partnership income goes to individual partners who did not perform the services producing the income. Under the 1939 law it followed that only a part of the compensation received by partnerships for services rendered over the requisite period could get the benefits of Section 107. In 1942 Congress decided that such a limitation was undesirable. Accordingly it amended Section 107 so as to afford the same benefits to all compensation of the specified type, regardless of whether the taxpayer reporting the income actually performed all or any of the services.



Congress did this by language too plain to be misunderstood. But in addition the congressional purpose was expressed in the Report of the Senate Finance Committee. That the general intent was to broaden the scope of the relief granted is indicated by the following sentence from the Committee's comments upon the section of the Revenue bill which amended Section 107 of the Internal Revenue Code:

"It is believed that the use of the term 'five calendar years' results in an inequitable limitation of the scope of such section and that there are also other restrictions in the existing law which prevent a proper application of this relief provision."

Senate Report No. 1631, 77th Cong., 2nd Sess.; 1942—2 Cum. Bul. 585.

More specifically, the Report states (1942—2 Cum. Bul. 586):

"In order for section 107(a) to be applicable, it is not necessary that the individual who includes in his gross income compensation for such personal services be the person who renders such services. For example, a partner who shares in compensation for such personal services rendered by the partnership may be entitled to the benefits of section 107(a), notwithstanding that he took no part in the rendering of such services. Likewise, in community property States, the spouse of a person who renders such personal services may be entitled to the benefits of section 107(a)."

The elimination of any requirement of participation in the rendition of the services is similarly recognized by the Income Tax Regulations. Regulations 111, Section 29.107-1 contains the following paragraph:

"It is not necessary, in order for section 107(a) to be applicable, that the individual who includes in his gross income compensation for such personal services be the person who renders the services. For example, a partner who shares in the compensation for such personal services rendered by



the partnership may be entitled to the benefits of section 107(a), notwithstanding that he took no part in the rendering of such services."

Not only is it unnecessary that the taxpayer reporting the income be the person who renders the services, but it is not even necessary that he be a member of the partnership, *provided* he is an individual in whose gross income "any part" of the compensation in question must be included. This is made clear by the Senate Finance Committee Report in the sentence, quoted above, which states that

"in community property States, the spouse of a person who renders such personal services may be entitled to the benefits of section 107(a)."

If Section 107(a) applies to a taxpayer who must report the income but is not even a member of the partnership at any time, *a fortiori* the section applies to a taxpayer who must report the income and who is a member of the partnership at the time the income is received, even though he has not been a member during the entire period over which the services have been rendered.<sup>1</sup>

The Commissioner in his Brief (pp. 18-19) attempts to escape from the consequences of the 1942 Amendment by stating that its purpose was merely "clarifying." But the trouble is that Congress has clarified the statute so completely that there is no room left for doubt as to its meaning. This is the fatal weakness of the Commissioner's case. Congress clarified the law by making it plain that it is no longer necessary that the individual who includes in his gross income compensation for personal services be the person who renders the services. Congress made it equally

---

<sup>1</sup>To be consistent the Commissioner would have to add another requirement to the effect that a wife could not have the benefit of Section 107(a) during the first 36 months after marriage.

explicit that all that is necessary is that the taxpayer be *any individual* who must include in his gross income *any part* of compensation of the specified sort. The Committee Report, in its reference to community property, further makes plain that this means what it says.

What the Commissioner seeks to do is, as we have said above, to write into the plain language of Congress the new requirement that a partner must have been such for 36 months or more, if he is to be covered. This is not "clarification," but complication, confusion and amendment. There is not the slightest justification, other than the Commissioner's own fiat, for attributing any such intent to Congress.

The Commissioner also states (Commissioner's Brief, p. 20) that the conclusion reached by the Tax Court is "contrary to the basic purpose of Section 107." In this connection he quotes from the Senate Finance Committee Report on the Revenue Act of 1939, to the effect that the purpose of Section 107 was to grant relief from the "hardship" falling upon persons "who work for long periods of time without pay." The Commissioner then says:

"There is no indication whatsoever that Congress, in amending the law in 1942, intended in any way to depart from that basic purpose."

Perhaps it is well to quote in full the paragraph of the 1939 Committee Report from which the Commissioner quotes in part. It reads (Senate Report No. 648, 76th Congress, 1st Session; 1939—2 Cum. Bul. 528):

"It has been considered a hardship to tax fully the compensation of writers, inventors, and others who work for long periods of time without pay and then receive their full compensation upon the completion of their undertaking. Under existing law, such persons have their income for the whole period aggregated into the final year. This results in two inequities: First, only the deductions, expenses, and credits of the final year are chargeable against the compensation

for the full period; second, under our graduated surtax, the taxpayer is subjected to a considerably greater burden because of the aggregation of his compensation."

It is common knowledge that the basic reason for the insertion of Section 107 into the Code was the hardship that results from the taxation in a single year of income which is the fruit of work which has been going on for a number of years. The relief is the spreading out of the income over such period of years for tax computation purposes. But this does not answer the question of what taxpayers are entitled to such relief, and the question is not answered in the above-quoted paragraph of the Committee report. The answer must be found in the statute itself. In the 1939 version of Section 107(a) Congress confined the relief to the individual who rendered the services, and the Committee Report was written in the light of that fact.

However, in the 1942 amendment Congress eliminated this restriction of the relief to the individual rendering the services. Hence as far as such restriction may be deemed to have been a part of the basic purpose of Section 107, there is every indication that Congress did intend to depart therefrom in its amendment of 1942. The Commissioner is mistaken in suggesting the contrary.

In the 1942 version Congress made the applicability of Section 107(a) depend, not on who rendered the services, but on who is taxable upon the income. By the explicit terms of Section 107(a), it applies to "the tax attributable to any part" of the compensation. "Any part" would apply to every part and therefore this phrase includes *all* of the compensation. Thus since 1942 it has been the "basic purpose" of Congress to afford the benefits of Section 107(a) to all compensation for sufficiently long-term services when "bunched" by receipt of 80% or more in one year, no matter who must report it. And there can be no fundamental injustice in such a broad legislative treatment of compensa-



tion for long-term services. No greater amount than 100% of the compensation for such services received in a single year can be thereby subjected to the tax computation benefits of Section 107(a) and thus no such benefits can be obtained by any one with respect to any other income than that derived from the long-term services. If the compensation is received by a partnership in a community property state, the aggregate income of all the partners and their wives which is thus entitled to be computed according to Section 107(a) cannot exceed the amount as to which an individual proprietor and his wife would obtain comparable benefits had he alone performed all the services and received all the compensation.

It should be recalled in this connection that the question of who can or must report income consisting of compensation for personal services is rigidly controlled by law. The taxpayer has no option. Compare *Lucas v. Earl* (1930), 281 U.S. 111, and similar cases. This limitation in itself is enough to dispose of the Commissioner's vague contention that to sustain Taxpayer's position "would lead to absurd and unreasonable consequences." (Commissioner's Brief, pp. 25-26.)

Far from being absurd or unreasonable the policy adopted by Congress in 1942 is simple, natural and understandable. Congress was concerned about compensation for long-term services, and it had a choice as between two types of legislation to afford relief from the heavy surtaxes which apply when such compensation for long-term services is "bunched" in a single year. It might have adopted a long and detailed statute differentiating between individuals, between partners of different types, between wives of partners, and employees of partnerships and others.

The fact is, however, that Congress chose the other legislative course. It adopted a broad and general provision classifying as entitled to the benefits of Section 107 all of the parties sharing in the qualified compensation without any limitation or exception.



This had every advantage of both legislative and administrative simplicity. The decision of Congress to adopt this course can be altered only by Congress itself.

**C. THE DECISION OF THIS COURT IN LINDSTROM v. COMMISSIONER, 149 F.2d 344, GIVES NO SUPPORT TO THE COMMISSIONER'S POSITION.**

The principal authority relied upon by the Commissioner in his argument is the decision of this Court in *Lindstrom v. Commissioner* (1945), 149 F.2d 344. This case, however, affords no support to his position for the simple reason that it arose under the 1939 version of Section 107 and before the 1942 amendment.

The case involved the 1940 taxes of petitioner Lindstrom and his wife, California residents, with respect to Lindstrom's share of a fee received in 1940 by a law partnership in which he and one Eckman were equal partners. Prior to the formation of the partnership Eckman had performed legal services for certain clients over a period of years. The fee for this work was not collected until after the formation of the partnership and accordingly the fee was divided equally between the two partners. At that time the partnership had been in existence for less than five years, which was the period specified in Section 107 as enacted in 1939.

This Court held that under these circumstances Lindstrom was not entitled to the benefits of Section 107 in computing his income tax on his half of the fees in question. The decision was undoubtedly correct, because as the law then stood the benefits of Section 107 were not available unless the taxpayer reporting the income also rendered the services for which the compensation was paid. The Court was careful to point out that the 1939 version of Section 107 was controlling and that the 1942 amendment did not apply. No consideration whatever was given to the question of what the proper result would be after 1942.

The Court did state that the statute had to be enforced as Congress had written it (p. 346):

"The will of Congress has been plainly expressed in language that does not permit or require a strained or unnatural interpretation. The words of the statute may not be extended or distorted beyond their plain, popular meaning. See *Helvering v. Hammel*, 311 U.S. 504, 61 S.Ct. 368, 85 L.Ed. 303, 131 A.L.R. 1481; *Woolford Realty Co. v. Rose*, 286 U.S. 319, 52 S.Ct. 568, 76 L.Ed. 1128."

This statement is just as true of the 1942 version as it was of the 1939 version. And under the Revenue Act of 1942 it is equally clear that Congress intended the opposite result in cases like this. Hence the decision in *Lindstrom v. Commissioner* has no application to years after 1942. All this was clearly recognized by the Tax Court in *Marshall, supra*, which decision was followed by that court in the present case. In the course of its opinion in the *Marshall* case, the Tax Court said (14 T.C. at 92-94):

"The parties are in apparent agreement that prior to the 1942 amendment respondent's position was the only tenable one. It was in fact so held. *Ralph G. Lindstrom*, 3 T.C. 686. But there the court took pains to point out on affirmance, *Lindstrom v. Commissioner* (C.C.A., 9th Cir.), 149 Fed. (2d) 344, 346, that:

' . . . The subsequent amendment of this section by Section 139 of the Revenue Act of 1942 does not apply as it relates only to taxable years beginning *after* December 31, 1940.'

"A comparison of the language of the section before and after the amendment demonstrates, however, that emphasis was reversed by the new provision and was removed from the person who renders the services to the person who is required to report the income. That this was intentional appears from the legislative history: . . .

"The fact, therefore, that petitioner could not have participated in the rendition of all of the services involved because he was not connected with the firm during the entire period of service would not of itself deprive him

of resort to it. . . . Once it is recognized that the requirement of actual participation in the services has been eliminated, we cannot perceive in these facts the inherent absurdity or lack of congressional intent to which respondent's fears are directed."

On page 16 of his brief the Commissioner also cites a memorandum by his own Chief Counsel,

*G.C.M. 25795, 1948—2 Cum. Bul. 61.*

It seems unnecessary to burden the Court with a discussion of that memorandum. It is apparently cited solely in support of the argument that the *Lindstrom* case applies as much after the 1942 amendment as before and this argument has already been sufficiently covered above. Other points discussed in the G.C.M. are so patently fallacious that the Commissioner's counsel on this appeal have not seen fit to repeat them in their brief. Furthermore, the opinion of government counsel is entitled to no greater weight when expressed in an office memorandum than when expressed in the government brief in this case. Incidentally that memorandum was issued at a time when the present cases were being considered by the Bureau of Internal Revenue and thus cannot be evidence of any administrative practice in effect during the taxable years 1944-5 here involved.

*Estate of Sanford v. Commissioner* (1939), 308 U.S. 39.

**D. TAXPAYER AND HIS WIFE MAY NOT BE DEPRIVED OF THE BENEFITS OF SECTION 107(a) ON THE THEORY THAT A NEW PARTNERSHIP WAS FORMED WHEN TAXPAYER BECAME A MEMBER.**

On pages 26-28 of his brief the Commissioner advances the theory that a new partnership was formed when Taxpayer became a member and that for that reason Taxpayer and his wife should be denied the benefits of Section 107(a). The same view was expressed by three dissenting judges of the Tax Court in the *Marshall* case.



The short answer to this point of view is that under Section 107(a) it is immaterial whether a new partnership was formed or not, when Taxpayer became a member. This is demonstrated by the analysis of the statute set forth earlier in this brief in part A. Congress has laid down in unmistakable terms the conditions upon which the application of Section 107(a) depends. There must be compensation for personal services covering a period of 36 calendar months or more, as there was here. Eighty per cent of such compensation must be received in one taxable year, as it was here. Next, the compensation must be received by an individual or a partnership. This condition is undeniably met here. The compensation was received by a partnership and this is just as true whether there was or was not a new partnership formed during the period over which the services were rendered.

The foregoing three conditions being met, Section 107(a) by its terms applies to "the tax attributable to any part [of such compensation] which is included in the gross income of any individual." "Any part" includes the compensation in question. "Any individual" includes Taxpayer and his wife. This is equally true regardless of whether technically a new partnership was or was not formed when Taxpayer became a member. There is no escape unless somebody legislates a change in the statutory language.

The Commissioner's position on this point illustrates once again how he is seeking to legislate, or to persuade this Court to do so, instead of leaving that function to Congress where the Constitution puts it. Congress might have inserted in Section 107(a) an additional condition that the same partnership must have continued in existence for a full 36 months, or for the full period over which the services were rendered. But Congress did not choose to do so and it is easy to understand why not.

Large law partnerships may be taken as an illustration. In such an organization changes in membership occur frequently, per-



haps as often as every year or so. Whether the routine admission of a new partner results in the formation of a new partnership or a mere continuation of the old one depends on the partnership agreement and on state law. The terms of the agreement vary from instance to instance. State law varies from state to state. On identical facts there may be a new partnership in one state and a continuation of the old firm in another state. Yet from a practical point of view it does not matter at all. The difference is a mere legal technicality.

In general, in the drafting of the Internal Revenue Code it has been the point of view of Congress that tax consequences should depend on practical considerations, rather than on the technical variations of state law. It would be most unusual if Congress should have made the application of Section 107(a) depend upon whether or not in the particular instance and in the particular state, the admission of a new partner resulted technically in the creation of a new partnership.

In any event Congress chose not to insert such a requirement into the statute and there is not the slightest justification for reading any such supposed legislative intent into the law under the guise of statutory construction. Congress has laid down the law in clear terms. If the Commissioner believes in a different policy, he should complain to that body.

Furthermore, even if Section 107(a) did require the continuous existence of the partnership throughout the period of services, such is the case here. The Uniform Partnership Act was adopted in California in 1929. That act contemplates the continuity of a partnership despite the admission of new members to it. For example, Section 17 (now to be found in the California Corporations Code, Section 15017) provides that when a person is "admitted as a partner into an existing partnership," he is liable, to the extent of partnership assets, for prior "obligations of the partnership," thus clearly implying the continued existence of the

same partnership. The admission of a new partner is through partial assignments by other partners of their interests; Section 27 of the Uniform Partnership Act (California Corporations Code, Sec. 15027) expressly provides that even a total assignment does not of itself dissolve the partnership, and the admission of a new partner is not a cause of dissolution under Sections 29 and 31. When a new partner is admitted, he is literally admitted *into* the *existing* partnership, which continues in being.

See: *White v. Long* (1927), 289 Pa. 525, 137 Atl. 673.

The continued existence of the partnership after a new member is taken in has been recognized for purposes of federal income taxes. In

*Commissioner v. Lehman* (CA 2, 1948), 165 F.2d 383,

it was held that for purposes of the forerunner of Section 117 of the Internal Revenue Code the holding period of a partner's interest in a partnership dated back to his entry into the firm even though another partner had been admitted between that date and the time of disposition of the interest. This is completely inconsistent with any view that, under the Uniform Partnership Act, a new partnership is created whenever a new partner is admitted to the firm, and demonstrates that the computation of statutory time periods under the income tax laws is not interrupted by such an event.

Indeed, even a technical dissolution of a partnership, as by the death of a partner, does not prevent the recognition for tax purposes of the continued existence of the partnership if its business is carried on. The tax year of the partnership is not cut short by such a dissolution.

*Girard Trust Co. v. United States* (C.A. 3, 1950), 182 F.2d 921;

*Commissioner v. Mnookin's Estate* (C.A. 8, 1950), 184 F.2d 89;

*Estate of Isidore Waldman* (1950), 15 T.C. No. 80;  
C.C.H. Dec. 17,918.

And no adjustment to the basis of the partnership assets is required whether or not a dissolution takes place.

*Cameron v. Commissioner* (C.A. 3, 1932), 56 F.2d 1021;  
*Ford* (1946), 6 T.C. 499; Acq: 1946—2 Cum. Bul. 2.

Likewise there is only one period for the computation of excessive profits under the Renegotiation Act despite a dissolution during the year.

*Callahan v. War Contracts Price Adjustment Board*  
(1949), 13 T.C. 355.

All of these cases recognize that the Uniform Partnership Act gives effect in legal theory to the continuity of business adopted in practice. Where, as here, the partnership continued its law practice uninterruptedly and the admission of the Taxpayer to membership was not even a technical dissolution of the firm, there is no justification for treating the case as involving two different firms. This is recognized in practice by the Commissioner inasmuch as no suggestion has ever been advanced to our knowledge that Section 107(a) does not apply to the old partners if a new partner is admitted during the period of services. Yet such would be the result of the argument which the Commissioner tentatively advances for the first time on appeal.

## II

### **Taxpayer and His Wife Are Entitled to Compute Their Taxes Under Section 107(a) Because of His Right for More Than Thirty-Six Months Prior to Receipt of Each Fee to Share in the Partnership Profits.**

As set forth above, it is our primary position that Taxpayer and his wife are entitled to the benefits of Section 107(a) regard-



less of whether or not Taxpayer had any connection with the partnership prior to August 1, 1943, the date on which he became a member of the firm.<sup>1</sup> However, if this Court should hold—contrary to what we believe to be the correct interpretation of the statute—that Congress intended to benefit only those individuals who had been themselves entitled to share in the fees for a period of 36 months or more, we further submit that Taxpayer and his wife are nevertheless within the ambit of Section 107(a). This is for the reason that Taxpayer for well over 36 months prior to the date of receipt of any of the fees here involved was entitled to share in the partnership profits, either as a partner or, prior to the date of his admission to the firm, as a profit-sharing employee.

As we have already stated at length, we see no justification for writing into the clear terms of Section 107(a) any new and additional restrictions which Congress itself did not choose to put there. But if there should be any substance at all in the Commissioner's position, we are completely unable to see how anything more could be written into the statute than the requirement that the taxpayer must have been entitled to share in the compensation in question for a period of 36 months or more.

The Commissioner's position is that the Taxpayer here must be entitled to share in the capacity of partner. But assuming the right to share, we are unable to see how, from the legislative point of view, it can conceivably matter whether this Taxpayer's right to a portion of the compensation is based upon his technical status as a partner or upon his contract with the firm as a profit-sharing employee. In either event the basic purpose of Section 107 would be equally applicable. If the actual legal fees involved in this case and which were "bunched" into the taxable years

---

<sup>1</sup>As we understand it, that is the sole question involved in the *Marshall* case, cited and discussed at pages 13, 17, 26 above, because the partner there involved became a partner within the period of 36 months and had not previously been on a profit-sharing basis as far as appears from the Tax Court's findings.



1944 and 1945 had, instead, been paid ratably over the periods during which the respective services were performed, this Taxpayer would have received his profit-sharing percentage thereof during the period of more than 36 months from January 1, 1940 to the time of receipt of the fees in 1944 and 1945. This would have been so by virtue of his profit-sharing agreements in effect from January 1, 1940 to August 1, 1943, and by virtue of his partnership percentage thereafter. The purpose of the statute is at least to give a taxpayer in such a situation the same tax benefits that he would have had if the income had been received ratably over the period of the services instead of being "bunched" into a single year, and the continued recognition of this purpose by Congress would prevent any amendment of the statute to eliminate this Taxpayer's case merely on the ground that he was not technically a partner.

The Commissioner seems to feel that since the Taxpayer had been fully paid his specified percentage of net profits under his employment agreements with the partnership prior to the period when he became a partner, this furnishes a further ground for differentiation between his case and the case of one who had been a partner during the whole period from and after January 1, 1940 (see Commissioner's Brief, pp. 22-23). It is true that if Taxpayer had retired from his job at the end of his period of employment on the profit-sharing basis, i.e., August 1, 1943, instead of becoming a partner on that date, he would not have been entitled to share in any fees subsequently received, and thus would not have had any right to any portion of the compensation received in 1944 and 1945, which is here involved. However, in this respect his situation would be no different whatsoever from that of a partner who had been a member of the firm during the period from January 1, 1940 to August 1, 1943, but who retired on the latter date. Under the stipulated practice of the partnership here involved, such partner likewise would have been fully

compensated by his percentage of fees received during the period prior to August 1, 1943, and would not have been entitled to any share of fees received in 1944 or 1945 (Stip. 12-13, R. 26-27). Thus there is not any distinction of substance in this respect between a partner and a profit-sharing employee.

And in any event the fact remains that either a partner or a profit-sharing employee who had been such during the period from January 1, 1940 to August 1, 1943 and had thereafter been a partner until the end of 1945, would have received his taxable income under lower surtax rates during the years 1940-43, inclusive, if the fees here in question had been paid ratably over the period of performance of the services. Thus either is entitled to the benefits of Section 107(a) under any fair interpretation of its purpose.

### CONCLUSION

The distinction mentioned above, which the Commissioner would make between the right existing for 36 months or more to share in compensation, on the one hand as a partner and on the other hand as a profit-sharing employee, brings out once again the legislative character of the Commissioner's views.

Assuming compensation of the specified sort, Congress has provided in clear and simple terms that Section 107(a) applies "*to any part thereof which is included in the gross income of any individual.*" The Commissioner would strike these words from the statute. He would substitute complicated provisions under which some individuals who are included within the actual language of Congress would remain within the scope of Section 107(a), while others would be excluded. He admits that not every taxpayer who benefits must have rendered the services for which the compensation is paid. But some taxpayers who did not render services are to be excluded. No guiding line of distinction having been provided by Congress, the Commissioner would himself supply it—or have this Court do so. The line of

distinction which he selects is between partners who have been such for 36 months or more and other taxpayers who equally are within the class actually described in Section 107(a). Also, he would draw a distinction between those entitled to share in compensation as partners or as profit-sharing employees.

The mere statement of distinctions like this, of which no suggestion can be found in the actual language of Congress, is sufficient to reveal that this is new legislation—not interpretation.

Whether or not taxpayers in this situation have to pay somewhat more or less income tax is not a matter of great public importance. But it is of critical public importance that our constitutional system of government be preserved. It is of critical public importance that the legislative powers of Congress be protected from encroachment by the other branches of government. To afford such protection is a basic function of this Court. That is the ultimate issue in this case.

Respectfully submitted,

HENRY D. COSTIGAN

STANLEY MORRISON

GORDON M. WEBER

1500 Balfour Building

San Francisco 4, California

*Attorneys for Respondents.*

McCUTCHEN, THOMAS, MATTHEW,

GRIFFITHS & GREENE

1500 Balfour Building

San Francisco 4, California

*Of Counsel*

Dated: December 7, 1950

**(Appendix follows)**









No. 12611

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

UNITED STATES OF AMERICA,  
Appellant,  
vs.

CALIFORNIA ELECTRIC POWER COM-  
PANY, a Corporation,  
Appellee.

---

Transcript of Record

---

Appeal from the District Court of the United States  
Southern District of California  
Central Division.

**FILED**

OCT 30 1950

PAUL P. O'BRIEN,  
CLERK





No. 12611

---

United States  
Court of Appeals  
For the Ninth Circuit

---

UNITED STATES OF AMERICA,  
Appellant,

vs.

CALIFORNIA ELECTRIC POWER COM-  
PANY, a corporation,  
Appellee.

---

Transcript of Record

---

Appeal from the United States District Court,  
Southern District of California,  
Central Division.



# INDEX

---

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

PAGE

Answer to United States of America..... 25

Appeal:

Appellant's Designation of Parts of Record

Believed Necessary for Consideration on 85

Appellant's Statement of Points to Be Re-

lied Upon on..... 83

Designation of Record on..... 81

Notice of ..... 79

Statement of Points Upon Which Defend-

ant (as Appellant) Intends to Rely on.. 79

Appellant's Designation of Parts of Record

Believed Necessary for Consideration on Ap-  
peal and to Be Printed..... 85

Appellant's Statement of Points to Be Relied

Upon on Appeal..... 83

Certificate of Clerk..... 81

Complaint to Recover Documentary Stamp

Taxes Illegally Assessed and Collected..... 2

Exhibit A—Letter dated December 16, 1941 8

B—Claim ..... 12

C—Letter Dated June 16, 1947... 22

INDEX	PAGE
Designation of Record on Appeal.....	81
Findings of Fact and Conclusions of Law.....	71
Judgment .....	77
Names and Addresses of Attorneys.....	1
Notice of Appeal.....	79
Opinion .....	64
Statement of Points Upon Which Defendant (as Appellant) Intends to Rely on Appeal...	79
Stipulation of Facts.....	28
Exhibit A—Amendment of the Certificate of Incorporation of the Cali- fornia Electric Power Co. Ef- fective June 30, 1941.....	34
B—Certified Copy of Resolution Adopted by Board of Directors of the Nevada-California Elec- tric Corp.....	62



## NAMES AND ADDRESSES OF ATTORNEYS

For Appellant:

ERNEST A. TOLIN,

United States Attorney,

E. H. MITCHELL,

Assistant U. S. Attorney,

EUGENE HARPOLE,

Special Attorney, Bureau of Internal  
Revenue,

600 U. S. Post Office & Court House  
Bldg.

Los Angeles 12, Calif.

For Appellee:

DEMPSEY, THAYER, DIEBERT &  
KUMLER,

1104 Pacific Mutual Bldg.,

Los Angeles 14, Calif.

In The District Court of The United States For  
The Southern District of California  
Central Division

No. 7888-B

CALIFORNIA ELECTRIC POWER COMPANY,  
a Corporation,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

COMPLAINT TO RECOVER DOCUMENTARY  
STAMP TAXES ILLEGALLY ASSESSED  
AND COLLECTED

Comes now the Plaintiff, and for cause of action  
against the Defendant alleges:

I.

That Plaintiff is a corporation duly organized  
and existing under and by virtue of the laws of the  
State of Delaware, duly licensed to engage in busi-  
ness in the State of California; that Plaintiff's  
principal office is located at 3771 Eighth Street,  
City of Riverside, County of Riverside, State of  
California, and in the Southern District of Califor-  
nia, Central Division.

II.

That the documentary stamp taxes in the amount  
of \$4,549.51, sought to be recovered herein, were  
paid on or about January 28, 1942, by the Plaintiff

to Ralph Nicholas, the duly appointed, qualified and acting Collector of Internal Revenue for the collection district comprising the State of Colorado.

### III.

That jurisdiction of this Court exists under Title 28, U. S. Code, Section 41 (5) and (20), and Section 762, and under Section 3772(a)(2) of the Internal Revenue Code.

### IV.

That by the amendment to its Certificate of Incorporation effective June 30, 1941, the name of the Plaintiff Corporation was changed from The Nevada-California Electric Corporation to California Electric Power Company.

### V.

That prior to June 30, 1941, the capital structure of the Plaintiff was as follows:

#### Outstanding Shares Immediately Prior

#### To June 30, 1941 Recapitalization

Old Preferred—105,023 sh. @ \$100 = \$10,502,300.00

Common — 84,683 sh. @ \$ 10 = 846,830.00

Total Capital Before Recapitalization \$11,349,130.00

### VI.

That by an amendment of the Certificate of Incorporation of the California Electric Power Company effective June 30, 1941, it was provided that each of the outstanding shares of old Preferred Stock should be automatically converted into four-fifths of a share of \$3.00 Cumulative Preferred Stock of the par value of \$50.00 each, and 6 shares of Common Stock. This was the sole and only change

made in the capital structure by said amendment to the Certificate of Incorporation. There was no change in Plaintiff's total capital stock account since the reduction in the Preferred Capital Stock account in the amount of \$60.00 per share was offset by a corresponding increase in the Common Capital Stock account. This conversion of stock created the following capital structure:

\$3.00 Cumulative Preferred Stock, 84,018.4 sh.	\$ 4,200,920.00
Common Stock, 714,821 sh.	7,148,210.00
Total.....	<u><u>\$11,349,130.00</u></u>

#### VII.

That on June 30, 1941, unpaid Cumulative Preferred dividends on the old Preferred Stock of Plaintiff Corporation amounted to \$11.00 per share.

#### VIII.

That in order to eliminate and settle the aforesaid arrearages in dividends, the stockholders and the Board of Directors of Plaintiff Corporation authorized the making of an offer to the preferred Stockholders that Plaintiff Corporation would issue one-fifth of a share of \$3.00 Cumulative Preferred Stock and \$1.00 in cash in settlement of all arrearages in dividends on each share of the old Preferred Stock, such offer to remain open until June 25, 1941.

#### IX.

That pursuant to said offer Plaintiff Corporation issued new \$3.00 Cumulative Preferred Stock at the rate of one share for each 5 shares of the old Preferred Stock to stockholders accepting the afore-



said offer, such new shares being issued if, as, and when the dividend arrearages were waived, and in exchange therefor. Upon completion of this exchange, new capital sufficient to pay the dividend arrearages was transferred from surplus to the Preferred Stock account, so that the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividends into additional shares of stock representing capitalized surplus.

## X.

That after the exchange of old Preferred Stock for the new \$3.00 Cumulative Preferred Stock and the issuance of new shares of new \$3.00 Cumulative Preferred Stock in settlement of dividend arrearages, the capital structure of Plaintiff Corporation was as follows:

1. Stock outstanding in hands of those accepting offer as to accumulated unpaid dividends on old Preferred:

New Preferred—104,722 sh. @ \$50.00 =	\$5,236,100.00
Common —628,332 sh. @ \$10.00 =	6,283,320.00

2. Stock outstanding in hands of those not accepting offer and holding 301 shares of the old Preferred:

New Preferred—240.8 sh. @ \$50.00 =	\$12,040.00
Common —1806 sh. @ \$10.00 =	18,060.00
Also New Preferred—.2 sh. @ \$50.00	
(Fractional sh.) =	10.00

3. Common Stock Previously Outstanding—84,683 shares.

## Totals:

New Preferred Stock—104,963 sh. @ \$50.00	\$ 5,248,150.00
Common Stock —714,821 sh. @ \$10.00	7,148,210.00

Total Capital After Exchanges of Stock	\$12,396,360.00
--	-----------------

Total Capital Before Exchanges of Stock	11,349,130.00
---	---------------

New Capital Added	\$1,047,230.00
-------------------	----------------

## XI.

That the number of shares of new Preferred Stock at \$50.00 per share issued up to January 24, 1942, was 103,398, of which four-fifths, or \$40.00 per share, was tax free, inasmuch as it represented a mere exchange for old Preferred Stock. There was involved, therefore,  $\$40.00 \times 103,398$  shares of old capital, or \$4,135,920.00, on which tax at \$.11 per \$100.00, or a total of \$4,549.51, was overpaid on, to-wit, January 28, 1942.

## XII.

That the Commissioner of Internal Revenue, by a letter dated December 16, 1941, addressed to the Collector of Internal Revenue at Denver, Colorado, a copy of which is attached hereto and made a part hereof, marked "Exhibit A," held that the entire issue of new \$3.00 Cumulative Preferred shares was subject to the original issue tax imposed by Section 1802(a) of the Internal Revenue Code, but that no tax attaches to the issuance of the additional Common shares as provided in the amendment of the Certificate of Incorporation.

## XIII.

That on or about January 24, 1946, and within four years of the date of payment of the aforesaid stamp tax in the amount of \$4,549.51, Plaintiff filed with the Collector of Internal Revenue at Denver, Colorado, a Claim for Refund of said stamp tax illegally and erroneously collected by said Ralph Nicholas as aforesaid, including interest thereon, as provided by law, a copy of which Claim is attached hereto and made a part hereof, marked "Ex-

hibit B.” Said Claim set forth, under oath, the grounds for refund and facts sufficient to apprise the said Collector, the Commissioner of Internal Revenue, and the Defendant, of the exact basis of the Claim.

#### XIV.

That the Commissioner of Internal Revenue, by letter dated June 16, 1947, erroneously and illegally rejected said Claim for Refund filed on or about January 24, 1946, as aforesaid, a copy of said letter of rejection being attached hereto and made a part hereof, marked “Exhibit C.”

#### XV.

That the said ruling of the Commissioner of Internal Revenue and the rejection of said Claim for Refund by said Commissioner were erroneous and invalid as to the four-fifths shares of \$3.00 Cumulative Preferred Stock issued in exchange for old Preferred Stock, and that the taxes paid on the issuance of any stock other than the one-fifth share of \$3.00 Cumulative Preferred Stock was illegally paid and collected and should be refunded, together with statutory interest thereon.

Wherefore, Plaintiff prays judgment upon the facts and law in the amount of \$4,549.51, together with interest thereon, as provided by law.

/s/ THOMAS R. DEMPSEY,  
/s/ WELLMAN P. THAYER,  
/s/ ARTHUR H. DEIBERT,  
/s/ WILLIAM L. KUMLER,  
Attorneys for Plaintiff.  
/s/ HENRY W. COIL,  
Associate Counsel.



State of California,  
County of Riverside—ss.

Howard Boylan, being first duly sworn on authority, deposes and says: That he is the official to-wit: Vice-President of California Electric Power Company, a corporation, Plaintiff above named, and as such verifies this Complaint on behalf of such corporation; that he has read the above and foregoing Complaint and knows the contents thereof; that the same is true of his own knowledge, except as to the matters which are therein stated on information or belief, and as to those matters that he believes it to be true.

/s/ HOWARD BOYLAN.

Subscribed and sworn to before me this 31st day of December, 1947.

[Seal] /s/ L. G. PECK,

Notary Public in and for the County of Riverside,  
State of California.

My Commission Expires July 3, 1950.

Exhibit A

Dec. 16, 1941

MT:M:REG

Collector of Internal Revenue,  
Denver, Colorado.

Attention: MT:CWR:FLC:

Reference is made to your letter of November 24, 1941, inclosing copies of documents relating to the



recapitalization of the Nevada-California Electric Corporation.

The corporation by amendment to its certificate of incorporation changed its name to California Electric Power Company.

Prior to the amendment of the company's certificate of incorporation there was authorized to be issued 250,000 shares of \$100.00 par value preferred stock and 250,000 shares of \$10.00 par value common stock. Pursuant to the terms of the amended certificate of incorporation the company was authorized to issue 200,000 shares of \$50.00 par value cumulative prior preferred stock, 115,000 shares of \$50.00 par value \$3.00 cumulative preferred stock and 1,200,000 shares of \$10.00 par value common stock. Upon the amendment becoming effective, each existing share of the old \$100.00 par value preferred stock was automatically converted and reclassified into four-fifths of a share of \$50.00 par value \$3.00 preferred stock and 6 shares of \$10.00 par value common stock.

On June 30, 1941, the unpaid cumulative preferred dividends on the old preferred stock amounted to \$11.00 per share.

The company offered to each holder of the existing preferred stock in full settlement of the \$11.00 per share preferred dividend arrears, \$10.00 par value, or one-fifth of a share, of the new \$3.00 preferred stock and \$1.00 in cash. The stockholders accepting this offer were required to surrender their old preferred shares in exchange for one full share of the new \$3.00 preferred stock, 6 shares of the

common stock and \$1.00 in cash. The preferred stockholders who did not elect to accept the offer were required to surrender their old preferred shares in exchange for four-fifths share of the new \$3.00 preferred stock and 6 shares of common stock for each share of the old preferred stock held.

The conversion of one share of the old \$100.00 par value preferred stock into four-fifths of a share of the new \$50.00 par value preferred stock and 6 shares of \$10.00 par value common stock, does not affect the company's total capital stock account, since the reduction in the preferred capital stock account in the amount of \$60.00 per share is offset by a corresponding increase in the common capital stock account. However, it appears that the \$3.00 cumulative preferred stock account is increased by the transfer from surplus account of an amount at least sufficient to take care of the \$3.00 cumulative preferred stock issued to pay the accrued dividends on the old \$100.00 par value preferred stock; that is, the aggregate of the one-fifth shares issued to the preferred stockholders who accept the company's offer to pay the accrued dividends in this manner.

The situation is, therefore, that at the effective date of the amendment to the certificate of incorporation an undisclosed number of \$100.00 par value preferred shares were issued against a preferred capital stock account in a certain amount, that 60 per cent of the amount of this account was absorbed in the common capital stock account against which common shares were issued, that an undisclosed amount of surplus was transferred to the \$3.00

cumulative preferred stock account and against this adjusted account all of the new \$3.00 cumulative preferred shares were issued, that is, not only the one-fifth share issued to pay the accrued preferred stock dividends but also the shares issued in exchange for the old preferred stock pursuant to the conversion as provided in the amendment to the certificate of incorporation. All of the new preferred shares were issued against the preferred stock account without any allocation. The inclusion of the old preferred capital stock account, or a part thereof, and the earned surplus in the new \$3.00 preferred capital stock account inured to the benefit of all of the preferred stockholders. Each received an interest in the new capital measured by the number of shares held. Thus each certificate constituted a new certificate of interest in the newly adjusted preferred capital of the company and, consequently, was of a kind never before issued. All of the shares represented precisely the same interest, all were issued under the same conditions and all were based on the same newly adjusted capital.

It is therefore ruled that all of the new \$3.00 cumulative preferred shares are subject to the original issue tax as imposed by section 1802(a) of the Internal Revenue Code.

The issuance, from time to time, of all or any part of the 200,000 shares of \$50.00 par value cumulative prior preferred stock will likewise be subject to the original issue tax.

No tax attaches to the issuance of the additional



common shares as provided in the amendment to the certificate of incorporation.

D. S. BLISS,  
Deputy Commissioner.

Exhibit B

Claim

To Be Filed With The Collector Where Assessment  
Was Made Or Tax Paid

The Collector will indicate in the block below the kind of claim filed, and fill in the certificate on the reverse side.

[xxx] Refund or Tax Illegally Collected.

[    ] Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.

[    ] Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

Collector's Stamp: (Date received) [blank].

State of California,  
County of Riverside—ss.

Name of taxpayer or purchaser of stamps—California Electric Power Company.

Business address—Riverside, California.  
Residence—

The deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below are true and complete:



1. District in which return (if any) was filed, Colorado.

2. Period (if for income tax, make separate form for each taxable year) from....., 19..., to .....  
....., 19.....

3. Character of assessment or tax, Documentary Stamp Tax.

4. Amount of assessment, \$4,552.31; dates of payment, January 28, 1942.

5. Date stamps were purchased from the Government .....

6. Amount to be refunded, \$4,549.51.

7. Amount to be abated (not applicable to income, gift, or estate taxes) .....

8. The time within which this claim may be legally filed, expires, under section 3313 I.R.C. on, to-wit, January 27, 1946.

The deponent verily believes that this claim should be allowed for the following reasons:

### Statement

#### I.

Taxpayer is and was, at all times herein referred to, a Delaware corporation, with offices at Denver, Colorado and Riverside, California.

#### II.

Prior to June 30, 1941, the capital structure of the California Electric Power Company was as follows:

## Outstanding Shares as of 1-1-41 :

Old Preferred—114,612 sh. at \$100 =	\$11,461,200
Common — 85,883 sh. at \$ 10 =	858,830

Total Capital .....	\$12,320,030
---------------------	--------------

## Shares Reacquired Prior to 6-30-41 :

Old Preferred—9,589 sh. at \$100 =	\$ 958,900
Common — 1,200 sh. at \$ 10 =	12,000

Total Reacquired .....	\$ 970,900
------------------------	------------

## Outstanding Shares Immediately Prior to 6-30-41 Recapitalization:

Old Preferred—105,023 sh. at \$100 =	\$10,502,300
Common — 84,683 sh. at \$ 10 =	846,830

Total Capital Before Recapitalization.....	\$11,349,130
--	--------------

## III.

By an Amendment of the Certificate of Incorporation of the California Electric Power Company effective June 30, 1941, it was provided that each of the outstanding shares of old Preferred Stock should be automatically converted into 4/5's share of \$3 Cumulative Preferred Stock of the par value of \$50 each, and 6 shares of Common Stock. This was the sole and only change made in the preferred capital or the total capital by the said Amendment to the Certificate of Incorporation. It created no increase in preferred capital or total capital, and standing alone, created the following capital structure:

\$3 Cumulative Preferred Stock.....	\$4,200,920
Common Stock .....	7,148,210
Total.....	\$11,349,130

However, at the same meetings of the Board of Directors and of the stockholders of the company at which the aforesaid Amendment was authorized, there was further authorized to be made an offer

to the old preferred stockholders, that provided the proposed Amendment became effective on or before June 30, 1941, the Corporation would issue 1/5 share of \$3 Cumulative Preferred Stock and \$1 in cash in settlement of all arrearage dividends on each share of old Preferred Stock, such offer to remain open until June 25, 1941.

The outstanding shares, after the above described recapitalization, were as follows:

1. Stock outstanding in hands of those accepting entire plan as to accumulated unpaid dividends on old Preferred:		
New Preferred—104,722 sh. @ \$50 =		\$ 5,236,100
Common —628,332 sh. @ \$10 =		6,283,320
2. Stock outstanding in hands of those not accepting plan and holding 301 shares of the old Preferred:		
New Preferred—240.8 sh. @ \$50 =	\$	12,040
Common —1806 sh. @ \$10 =		18,060
Also New Preferred—.2 sh. @ \$50 (a/c Fract. sh.) =		10
3. Common Stock Previously Outstanding.....		846,830
Totals:		
New Preferred—104,963 sh. @ \$50 =	\$	5,248,150
Common —714,821 sh. @ \$10 =		7,148,210
Total Capital After Recapitalization .....	\$12,396,360	
Total Capital Before Recapitalization .....	11,349,130	
New Capital Added .....	\$ 1,047,230	

#### IV.

Section 1802 (a) of the Internal Revenue Code as it existed on June 30, 1941, provided the following stamp tax: "On each original issue, whether on organization or reorganization, of shares or certificates of stock \* \* \* on each \$100 of par or face value or fraction thereof of the certificates issued by such corporation \* \* \* 11 cents \* \* \*"



## V.

The number of shares of new Preferred Stock at \$50 per share issued to January 24, 1942, was 103,398, on which  $\frac{4}{5}$  or \$40 per share, was tax-free, inasmuch as it represented a mere exchange for old Preferred Stock. There was involved, therefore, \$40 x 103,398 of old capital, or \$4,135,920, on which tax at \$.11 per \$100, or \$4,549.10, was overpaid on, to-wit, January 28, 1942.

## VI.

The Deputy Commissioner of Internal Revenue, by a letter dated December 16, 1941, addressed to the Collector of Internal Revenue at Denver, Colorado, copy of which is attached hereto and made a part hereof marked Exhibit "A," held that all of the new \$3 Cumulative Preferred Shares were subject to the Original Issue tax imposed by Section 1802 (a) of the Internal Revenue Code, but that no tax attaches to the issuance of the additional Common Shares as provided in the Amendment of the Certificate of Incorporation.

The corporation contends that such ruling is erroneous and invalid as to the  $\frac{4}{5}$ 's shares of \$3 Cumulative Preferred Stock, and that the taxes paid on the issuance of any stock other than the  $\frac{1}{5}$  shares of \$3 Cumulative Preferred Stock was illegally paid and collected, and should be refunded together with statutory interest thereon.

## VII.

It has generally been held that no tax is due on



an exchange of shares for shares on reorganization where there is no increase of capital.

Bowers v. West Va. P. & P Co., 297 Fed. 225.

American L.M. Co., v. Dean, 292 Fed. 620.

Trumbull Steel Co. v. Routzahn 292 Fed. 1009.

Standard Mfg. Co. v. Heiner, 300 Fed. 252.

This is so even where the class or kind of new stock differs from the class or kind of old stock or when two classes of stock are issued in lieu of one class of old stock.

Re Grand-Lees Gear Co., 1 Fed (2d) 293.

Cleveland Prov. Co. v. Weiss, 4 Fed. (2d) 408.

Cuba Ry. Co. v. U. S., 60 Ct. Claims 272.

Goodyear T. & R. Co. v. U. S., 60 Ct. Claims 448.

Bailey Co. v. Routzahn, 15 A.F.T.R. 497.

## VIII.

Section 113.25 of Regulations 71, in effect June 30, 1941, listed among stock issues not subject to the tax the following: “(f) The issue of stock in a recapitalization or reorganization where there is no dedication of additional capital, either by transfer of earned surplus or otherwise.”

## IX.

On May 13, 1943, the Seventh Circuit Court of Appeals decided the case of United States v. Pure Oil Company, 135 Fed. (2d) 578, in which the facts

closely parallel those of the present case. In the course of its opinion the Court stated the pertinent facts and reached conclusions of law as follows:

“On April 1, 1936, defendant had outstanding certain shares of preferred stock on which there were unpaid accumulated dividends, on 8 per cent stock, of \$25.50 per share, on 6 per cent stock, \$19.125 per share. Defendant proposed, and its shareholders agreed, their certificates be exchanged, share for share, for equal shares of new preferred stock, paying a lower dividend, plus additional shares of new stock in satisfaction of the unpaid dividends. As a result, 264,226 shares of outstanding preferred stock were surrendered and an equivalent number of shares of new preferred delivered to the holders, who received also 56,115 shares of new stock in satisfaction of unpaid dividends.”

“\* \* \* Defendant recognized that the shares issued in satisfaction of unpaid dividends were within the term ‘original issue’ and paid the tax upon them. The Government contended, and the trial court found, that the certificates for 264,226 shares issued in exchange for outstanding stock constituted likewise an original issue. The propriety of that conclusion is now questioned.”

“The statute clearly indicates that, to be taxable, certificates must be, in point of time, the first issued, whereby the issuing corporation certifies ownership by its shareholders of their aliquot parts of the capital represented by the certificates. By specifying ‘original issue’ we think it clear that the Congress did not intend to tax each issue but only that which

precedes all other issues subsequently made when original certificates are surrendered and new ones delivered in their place to the same shareholders for no new monetary consideration. *Edwards v. Wabash Railway Co.*, 2 Cir., 264 F. 610. Nor do we think it of any importance whether shares are converted into identical or variant stock or whether preferred is exchanged for common or common for preferred, with resulting differences in rights and privileges, for the test is not whether the reissue is of different type but, rather, whether it is 'original'."

"It was to defendant's interest to liquidate its unpaid accumulated dividends and to bring about a lower dividend for the future. When, with this end in view, defendant issued an equal amount of new stock for that part of the corporate assets represented by previously existing shares, it made no addition to its capital. It accomplished nothing other than replacement of older preferred stock with new, smaller dividend stock; the holders retained the same proportionate interests in the capital assets. The additional shares issued in satisfaction of unpaid dividends represented the only contribution to capital effectuated; that and that alone was an original issue, *Edwards v. Wabash Railway Co.*, 2 Cir. 264 F. 610; *Trumbull Steel Co. v. Routzahn*, D. C., 292 F. 1009; *Routzahn v. Trumbull Steel Co.*, 6 Cir., 300 F. 1006; *West Virginia Pulp & Paper Co. v. Bowers*, D. C., 293 F. 144, affirmed 2 Cir., 297 F. 225, certiorari denied 265 U. S. 584, 44 S.Ct. 459, 68 L.Ed. 1191; *Standard Manufacturing Co. v. Heiner*, D. C., 300 F. 252; *Cuba Railway Co. v.*



United States, 60 Ct.Cl. 272; Cleveland Provision Co. v. Weiss, D. C., 4 F, 2d 408; In re Grant-Lees Gear Co., Bankrupt, D. C., 1 F. 2d 393.”

“The Government insists that the entries upon the corporate books fail to disclose any shares specifically designated as a substitution for old certificates. It suggests that inasmuch as no shares were issued in lieu of any certain specified shares and no specific certificates charged against capital or surplus, it is impossible to classify the entire new issue as other than original. But book entries alone are not decisive. *Rio Grande Oil Company v. Welch*, 9 Cir., 101 F.2d 454. And, so here, we receive no enlightenment from the formal ledger capital set-up. The undisputed fact is that the old preferred stock was exchanged share for share and the dividend arrears satisfied by issuance of additional shares. Whatever the book entries, the only new thing that could properly have gone into the capital account was the contribution by the shareholders of their unpaid dividends to the corporation in consideration of which they received the additional shares.”

“The Government insists that the pronouncement of *Rio Grande Oil Company v. Welch*, supra, leads necessarily to the conclusion that the entire issue was original. But the basis for decision in that case is absent here in that there the court found that a transaction effectuated a complete reorganization and a fundamental change in the entire capital structure. Here the corporate structure remained the same except as to the additional shares issued in



satisfaction of unpaid dividends.”

The essential fact as stated by the Court in the above case is identical with that in the present case, viz., that the corporate structure remained the same except as to the additional shares issued in satisfaction of unpaid dividends, and only the latter may be subjected to the tax.

The Government made no application for certiorari in the foregoing case.

### X.

Wherefore, taxpayer requests and demands refund of the aforesaid amount of money in the sum of \$4,549.51 as paid by it to the Collector of Internal Revenue for documentary stamps, together with interest thereon as provided by law.

### XI.

Claimant requests and demands such further or additional refund or refunds as may now or hereafter appear to be due it by reason of the foregoing or on account of (a) any mistake in fact or in law made by it or any officer, clerk or other employee of the United States Treasury Department, amendment and/or adjustment of the said return, (b) any mistake in the payment and/or collection of the tax made by any person designated in subdivision (a) of this paragraph, (c) any erroneous or illegal requirement or regulation of any officer, clerk or other employee of the United States Treasury Department, (d) any repealed law, whether heretofore or hereafter repealed, (e) any unconstitutional law,

whether heretofore or hereafter declared unconstitutional, or (f) any other act or matter in connection with the said return, whether covered by the foregoing or not so covered.

CALIFORNIA ELECTRIC  
POWER COMPANY,

By /s/ H. BOYLAN,  
Vice-President.

Sworn to and subscribed before me this 14th day  
of January, 1946.

/s/ L. G. PECK,

Notary Public in and for the County of Riverside,  
State of California.

My commission expires July 3, 1946.

Exhibit C

Treasury Department  
Washington 25

Office of  
Commissioner of  
Internal Revenue  
Refer to  
MT:M:HB  
Cl. C-43849

June 16, 1947

California Electric Power Company,  
Riverside, California.

Gentlemen:

Your claim for redemption of used documentary  
stamps in the amount of \$4,549.51 has been ex-

amined. The tax was paid on the issuance of shares of capital stock by your corporation in connection with your recapitalization.

From the evidence on file in the case it appears that your corporation on June 30, 1941, by amendment to its certificate of incorporation changed its name from Nevada-California Electric Corporation to California Electric Power Company, and provided for certain changes in its capital structure. Prior to its recapitalization your corporation had outstanding 105,023 shares of \$100.00 par value preferred stock representing a capital of \$10,502,300.00 and 84,683 shares of \$10.00 par value common stock representing a capital of \$846,830.00 or a total capital of \$11,349,130.00. Upon the amendment to the certificate of incorporation becoming effective, each outstanding share of the old \$100.00 par value preferred stock was automatically converted into four-fifths of a share of \$50.00 par value \$3.00 preferred stock and 6 shares of \$10.00 par value common stock.

On June 30, 1941, the unpaid cumulative dividends on the old preferred stock amounted to \$11.00 per share. The corporation offered to each holder of the existing preferred stock in full settlement of the \$11.00 per share preferred dividend arrears, one-fifths of a share of the new \$3.00 preferred stock and \$1.00 in cash. The stockholders accepting this offer were required to surrender their old preferred shares in exchange for one full share of the new \$3.00 preferred stock, 6 shares of the common stock and \$1.00 in cash. The preferred stockholders who



did not elect to accept the offer were required to surrender their old preferred shares in exchange for four-fifths share of the new \$3.00 preferred stock and 6 shares of common stock for each share of the old preferred stock held. The holders of 301 shares of old preferred stock did not accept the above-described offer. The \$3.00 cumulative preferred stock account was increased by the transfer from surplus account of \$1,047,230.00 to take care of the \$3.00 cumulative preferred stock issued to pay the accrued dividends on the old \$100.00 par value preferred stock; that is, the aggregate of the one-fifth share issued to the preferred stockholders who accepted the company's offer to pay the accrued dividends in this manner.

Shares or certificates of stock are said to be of "original issue" when they are issued against capital which for the first time is included in the capital stock account. In the above transaction, the amount of \$1,047,230.00 which was transferred from surplus represented capital never previously included in the capital preferred stock account. The old capital and the new capital were intermingled in such a way that it is impossible to determine which specific shares are represented by the new capital added to the preferred stock account. Each preferred stockholder received an interest in the new capital measured by the number of shares held. Each preferred share issued thus constituted a new certificate of interest in the newly adjusted preferred capital of the corporation and, consequently, was a kind never before issued.



In view of the foregoing, it is held that documentary stamps in the correct amount were properly affixed and canceled on the issuance of the new \$3.00 cumulative preferred shares. Accordingly, your claim is rejected.

Very truly yours,

JOSEPH D. NUNAN JR.,

Commissioner.

By /s/ D. S. BLISS,

Deputy Commissioner.

[Endorsed]: Filed January 6, 1948.

---

[Title of District Court and Cause.]

No. 7888-B Civil

ANSWER OF UNITED STATES  
OF AMERICA

Comes now the defendant in the above-entitled action and for answer to plaintiff's complaint admits, denies and alleges, as follows:

I.

Paragraph numbered I is admitted.

II.

Paragraph numbered II is admitted.

III.

Paragraph numbered III contains no allegation of fact and, therefore, does not require answering.

## IV.

Paragraph numbered IV is admitted.

## V.

Paragraph numbered V is admitted.

## VI.

The first and second sentences of paragraph numbered VI are admitted. The balance of the paragraph is denied.

## VII.

Paragraph numbered VII is admitted.

## VIII.

Paragraph numbered VIII is admitted.

## IX.

Paragraph numbered IX is admitted.

## X.

Paragraph numbered X is admitted.

## XI.

Paragraph numbered XI is denied.

## XII.

Paragraph numbered XII is admitted.

## XIII.

Answering paragraph numbered XIII, it is admitted that plaintiff filed on January 14, 1946, a

claim for the refund of \$4,549.51, and that the Exhibit B, attached to the complaint, is a copy of such claim, but any statement contained in said claim, which is not specifically admitted in this answer, is hereby denied. Except as herein admitted the whole of said paragraph is denied.

XIV.

Answering paragraph numbered XIV, it is admitted that the Commissioner of Internal Revenue rejected said claim and that the Exhibit C, attached to the complaint, is a copy of the Commissioner's letter advising of such rejection; but it is denied that any part of the claim was erroneously or illegally rejected.

XV.

Paragraph numbered XV is denied.

Wherefore, the defendant having fully answered prays that the plaintiff take nothing by its action and that the defendant recover its costs.

JAMES M. CARTER,  
United States Attorney,

E. H. MITCHELL and  
GEORGE M. BRYANT,  
Assistant United States  
Attorneys,

EUGENE HARPOLE,  
Special Attorney, Bureau  
of Internal Revenue.

By /s/ GEORGE M. BRYANT,  
Attorneys for Defendant.

[Endorsed]: Filed December 27, 1948.

---

[Title of District Court and Cause.]

### STIPULATION OF FACTS

It Is Hereby Stipulated by and between California Electric Power Company, a corporation, Plaintiff, and the United States of America, Defendant, by their respective counsel, that the following facts shall be taken as true; provided, however, that this stipulation shall be without prejudice to the right of either party to object at the trial to any part thereof on the grounds of immateriality or to introduce other and further evidence not at variance with the facts herein stipulated:

(1) That California Electric Power Company is a corporation duly organized and existing under and by virtue of the laws of the State of Delaware, duly licensed to engage in business in the State of California; that California Electric Power Company's principal office is located at 3771 Eighth Street, City of Riverside, County of Riverside, State of California, and in the Southern District of California Central Division.

(2) That the documentary stamp taxes here involved, in the amount of \$4,549.51, were paid on or about January 28, 1942, by the California Electric Power Company to Ralph Nicholas, the duly ap-



pointed, qualified and acting Collector of Internal Revenue for the collection district comprising the State of Colorado.

(3) That by amendment to its Certificate of Incorporation effective June 30, 1941, the name of the California Electric Power Company was changed from The Nevada-California Electric Corporation to California Electric Power Company.

(4) That prior to June 30, 1941, the capital structure of the California Electric Power Company was as follows:

Outstanding Shares Immediately Prior to June 30, 1941, Recapitalization		
Old Preferred—105,023 sh. @ \$100 =		\$10,502,300.00
Common — 84,683 sh. @ \$10 =		846,830.00
Total Capital Before Recapitalization....		<u><u>\$11,349,130.00</u></u>

(5) That by an amendment of the Certificate of Incorporation of the California Electric Power Company effective June 30, 1941, a copy of which is attached hereto marked "Exhibit A" and made a part hereof, it was provided that each of the outstanding shares of old Preferred Stock should be automatically converted into four-fifths of a share of \$3.00 Cumulative Preferred Stock of the par value of \$50.00 each, and 6 shares of Common Stock of the par value of \$10.00 each. This was the sole and only change made in the capital structure by said amendment to the Certificate of Incorporation.

(6) That on June 30, 1941, unpaid Cumulative Preferred dividends on the old Preferred Stock of

California Electric Power Company amounted to \$11.00 per share.

(7) That in order to eliminate and settle the aforesaid arrearages in dividends, the stockholders and the Board of Directors of California Electric Power Company authorized the making of an offer to the preferred stockholders that California Electric Power Company would issue one-fifth of a share of \$3.00 Cumulative Preferred Stock and \$1.00 in cash in settlement of all arrearages in dividends on each share of the old Preferred Stock, such offer to remain open until June 25, 1941. A copy of the resolution authorizing such offer is attached hereto, marked "Exhibit B" and made a part hereof.

(8) That pursuant to said offer, California Electric Power Company issued new \$3.00 Cumulative Preferred Stock at the rate of one share for each 5 shares of the old Preferred Stock to stockholders accepting the aforesaid offer, such new shares being issued if, as, and when the dividend arrearages were waived, and in exchange therefor. Upon completion of this exchange, new capital sufficient to pay the dividend arrearages was transferred from surplus to the Preferred Stock account, so that the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividend into additional shares of stock representing capitalized surplus.

(9) That after the exchange of old Preferred Stock for the new \$3.00 Cumulative Preferred Stock

and the issuance of new shares of new \$3.00 Cumulative Preferred Stock in settlement of dividend arrearages, the capital structure of California Electric Power Company was as follows:

(a) Stock outstanding in hands of those accepting offer as to accumulated unpaid dividends on old Preferred:

New Preferred—104,722 sh. @ \$50.00 .....	\$ 5,236,100.00
Common —628,332 sh. @ \$10.00 .....	6,283,320.00

(b) Stock outstanding in hands of those not accepting offer and holding 301 shares of the old Preferred:

New Preferred—240.8 sh. @ \$50.00 .....	\$ 12,040.00
Common — 1806 sh. @ \$10.00 .....	18,060.00
Also New Preferred .2 sh. @ \$50.00	
(Fractional sh.) .....	10.00

(c) Common Stock Previously Outstanding—84,683 shares.

Totals:

New Preferred Stock—104,963 sh. @ \$50.00 ....	\$ 5,248,150.00
Common Stock —714,821 sh. @ \$10.00....	7,148,210.00

Total Capital After Exchange of Stock.....	12,396,360.00
--	---------------

Total Capital Before Exchanges of Stock.....	11,349,130.00
--	---------------

New Capital Added .....	\$ 1,047,230.00
-------------------------	-----------------

(10) That the number of shares of new Preferred Stock at \$50.00 per share issued up to January 24, 1942 was 103,398.

(11) That the Commissioner of Internal Revenue, by a letter dated December 16, 1941, addressed to the Collector of Internal Revenue at Denver, Colorado, a copy of which is attached hereto and made a part hereof, marked "Exhibit C," held that the entire issue of new \$3.00 Cumulative Pre-



ferred shares was subject to the original issue tax imposed by Section 1802 (a) of the Internal Revenue Code, but that no tax attaches to the issuance of the additional Common shares as provided in the amendment of the Certificate of Incorporation, hereinabove referred to.

(12) That California Electric Power Company has paid, and concedes that it was liable for such payment, documentary stamp taxes at the rate of \$.11 per \$100.00 on the amount of new capital added to its capital account in cancellation of dividend arrearages and against which new Preferred Stock was issued. That the additional sum of \$4,549.51, here in dispute, was paid on the value of the balance of new Preferred Stock issued up to January 24, 1942 in response to the Ruling described in the preceding paragraph.

(13) That on or about January 24, 1946 California Electric Power Company filed with the Collector of Internal Revenue at Denver, Colorado, a Claim for Refund of stamp taxes paid in the amount of \$4,549.51, together with interest thereon as provided by law, a copy of which claim is attached hereto, marked "Exhibit D."

(14) That the Commissioner of Internal Revenue, by letter dated June 16, 1947, rejected said Claim for Refund filed on or about January 24, 1946, as aforesaid, a copy of said letter of rejection be-



ing attached hereto and made a part hereof,  
marked "Exhibit E."

DEMPSEY, THAYER,  
DIEBERT & KUMLER,

By /s/ ARTHUR H. DEIBERT,  
Attorneys for Plaintiff.

JAMES M. CARTER,  
United States Attorney,

E. H. MITCHELL,  
Assistant United States  
Attorney,

EUGENE HARPOLE,  
Special Attorney, Bureau  
of Internal Revenue,

By /s/ EUGENE HARPOLE,  
Attorneys for Defendant.

## Exhibit A

Certified Copy of Amendment to the Certificate of Incorporation of The Nevada-California Electric Corporation (Named Changed June 30, 1941, to California Electric Power Company) Adopted by Stockholders of Said Company at a Special Meeting Held June 20, 1941.

## I.

To strike out Article First of the Certificate of Incorporation and to insert in lieu thereof the following:

First: The name of this Corporation is and shall be California Electric Power Company. Said corporation is sometimes hereinafter in this Certificate of Incorporation called "the Company" or "this Corporation."

## II.

To strike out the paragraphs numbered, respectively, (1) and (2) of Article Third of the Certificate of Incorporation as amended, and to insert in lieu thereof the following:

(1) To build, construct, erect, equip, repair, rebuild, improve, buy, sell, let, license, lease, use and operate plants, lines and works for the generation, transmission, distribution and other use of electric energy; also telegraph and telephone lines, plants and works, water works and plants, gas works and plants, oil and gas wells and oil and gas producing plants, dams, reservoirs, flumes, pipe lines, ditches, canals, aqueducts, water courses, hydraulic works,

and all other classes and kinds of plants, works, buildings, structures and improvements, together with all appurtenances incident thereto, or to the business of this Corporation, and to furnish the necessary labor and materials used or to be used in connection with any part of its business, and to sell or otherwise dispose of the products of or the services or facilities rendered by all such plants, lines, works and other property, and to do business as a public utility under the laws of the several states and the United States, or any of them, and to have and exercise the right of eminent domain as now or hereafter provided by law.

(2) To build, construct, erect, equip, repair, rebuild, improve, buy, sell, let, license, lease, use and operate real property, patent rights, mineral rights, rights to chemical processes, plants, lines, and works for the manufacture or use of ice, carbon dioxide and other refrigerants, whether now or hereafter developed, works for the manufacture or use of refrigerating or freezing processes, whether now or hereafter developed, and facilities for the storage, refrigerated or otherwise, of perishable or other articles or commodities, and to sell or otherwise dispose of the products of or the services or facilities rendered by all such plants, lines, works and other property.

### III.

To strike out all of Article Fourth of the Certificate of Incorporation as heretofore amended (except the last paragraph thereof which reads as follows: "The amount of the capital stock with which

this Corporation shall commence business is one hundred thousand, three hundred dollars (\$100,300.00); being one thousand and three (1,003) shares, of the par value of one hundred dollars (\$100.00) each'') and to insert in lieu of that part of said Article so stricken the following:

Fourth: The total number of shares of all classes of stock which the Company shall have authority to issue is 1,515,000 shares, divided into 200,000 shares of Cumulative Prior Preferred Stock of the par value of Fifty Dollars (\$50) each, 115,000 shares of \$3 Cumulative Preferred Stock of the par value of Fifty Dollars (\$50) each and 1,200,000 shares of Common Stock of the par value of Ten Dollars (\$10) each.

#### Subdivision I. Cumulative Prior Preferred Stock

1. Subject to the limitations and provisions in this Article Fourth, the Cumulative Prior Preferred Stock (hereinafter in this Article Fourth sometimes called "prior Preferred Stock") may be issued from time to time in one or more series and in such amounts, not to exceed the total authorized herein, as may be determined by the board of directors. The designations, powers, preferences and relative, optional, conversion and other special rights, and the qualifications, limitations and restrictions thereof, of the Prior Preferred Stock of each series shall be such as are stated and expressed herein and, to the extent not stated and expressed herein, shall be such, not inconsistent with the pro-



visions of this Article Fourth, as may be fixed by the board of directors (authority so to do being hereby expressly granted) and stated and expressed in a resolution or resolutions adopted by said board providing for the issue of Prior Preferred Stock of such series. The words "fixed for such series" shall refer to terms and provisions which are fixed by the board of directors pursuant to such authority and stated and expressed in a resolution or resolutions adopted by said board providing for the issue of Prior Preferred Stock of such series.

2. The holders of Prior Preferred Stock of each series shall be entitled to receive, when and as declared by the board of directors, out of any funds or assets legally available for that purpose, preferential cumulative non-interest-bearing dividends in cash at the rate, not exceeding 7% of the par value per share per annum, fixed for such series and shall not be entitled to receive any dividends over and above such preferential dividends. Such preferential dividends shall be payable quarterly on January 1, April 1, July 1 and October 1 in each year except that with respect to any Prior Preferred Stock issued within 30 days preceding any of such dates, the initial preferential dividend may be paid on the next succeeding dividend payment date. Such preferential dividends shall accrue and be cumulative from the date or dates fixed for each such series. Such preferential dividends shall be declared and paid or set apart for payment in full for all previous quarterly dividend periods before the declaration of, or payment of, or setting apart any

funds or assets for payment of, any dividends on, or the making of or the setting apart of any funds or assets for any distribution with respect to, any class of junior stock, as hereinafter defined, and before any purchase, redemption or other acquisition of any class of junior stock, or the setting apart of any funds or assets for such purchase, redemption or acquisition. For all purposes of this Subdivision I the term "junior stock" shall mean \$3 Cumulative Preferred Stock, Common Stock and any other class of stock hereafter authorized except (i) Prior Preferred Stock and (ii) any future class of stock authorized in compliance with Section 9(b) or 9(c) of this Subdivision I and ranking prior to or on a parity with the Prior Preferred Stock as to dividends or assets. Each share of Prior Preferred Stock shall rank on a parity with each other share of Prior Preferred Stock, irrespective of series, with respect to the preferential dividends at the respective rates fixed for such series, and no preferential dividend shall be declared or paid or set apart for payment on any series unless at the same time a dividend in like proportion to the preferential dividends accrued upon the Prior Preferred Stock of each other series, shall be declared or paid or set apart for payment, as the case may be, on each other series then outstanding.

The Company shall not pay dividends out of capital surplus on Prior Preferred Stock if at the time of, or as a result of, such payment, the amounts of dividends paid on the Prior Preferred Stock out of capital surplus, and not restored by charges to

earned surplus, shall exceed Five Hundred thousand dollars (\$500,000). In the event that any dividends shall be paid on the Prior Preferred Stock out of capital surplus, no dividends shall thereafter be paid on any shares of junior stock until capital surplus shall have been restored by charges to earned surplus in an amount equal to such dividend payments out of capital surplus.

3. At any time after all preferential dividends on the Prior Preferred Stock of all series for all previous quarterly dividend periods shall have been declared and paid or set apart for payment, the board of directors may, after or concurrently with, but not before, the declaration of full preferential dividends on the Prior Preferred Stock of all series for the current quarterly dividend period, declare dividends (payable in cash, property or stock) on outstanding shares of junior stock (subject to the observance of any applicable priorities as between classes of junior stock), out of any funds or assets legally available for that purpose; provided, however, that no dividends on any junior stock shall be paid, set apart for payment, or be payable, before full preferential dividends shall have been paid or set apart for payment on the Prior Preferred Stock of all series for the quarterly dividend period for which such dividend on junior stock shall have been declared. All dividends declared upon any junior stock shall be subject to the provisions of this Section 3 and to the provisions of Section 2 and paragraphs (e) and (f) of Section 9 of this Subdivision I of this Article Fourth.



4. In the event of any voluntary liquidation, dissolution or winding up of the Company or any distribution of the capital of the Company, the holders of Prior Preferred Stock of each series shall be entitled to receive from the assets of the Company, whether represented by capital, surplus, reserves or earnings, such preferential amount, in cash, not exceeding \$55 per share, as may be specifically fixed for such series, and in the event of any involuntary liquidation, dissolution or winding up of the Company, the holders of the Prior Preferred Stock of all series shall be entitled to receive from the assets of the Company, whether represented by capital, surplus, reserves or earnings, a preferential amount in cash equal to \$50 per share, and in each case, whether voluntary or involuntary, a further preferential amount in cash equal to all accrued and unpaid preferential dividends thereon to the date payment is made available to the Prior Preferred Stockholders; all of which shall be paid or set apart for payment before or concurrently with the payment of or setting apart for payment of any amount for, or the distribution of any assets of the Company to, the holders of any junior stock. Each share of Prior Preferred Stock shall rank on a parity with each other share of Prior Preferred Stock, irrespective of series, with respect to the preferential amounts payable upon any distribution of assets by way of liquidation, dissolution or winding up of the Company, and no such amounts shall be paid or set apart for payment on any series unless



at the same time amounts in like proportion to the respective preferential amounts to which the shares of each other series are entitled, shall be paid or set apart for payment on each other series then outstanding. After payment or the setting apart for payment to the holders of Prior Preferred Stock of the preferential amounts so payable to them, all the remaining assets of the Company shall belong to and be distributable to the holders of junior stock in accordance with any applicable priorities as between classes of junior stock.

5. Subject to the provisions of this Section 5, the whole or any part of the Prior Preferred Stock of any series which is made redeemable by the resolution or resolutions providing for the issue of Prior Preferred Stock of such series may, unless preferential dividends on Prior Preferred Stock not then to be redeemed are in arrears on the date on which notice of redemption is given, be redeemed at the option of the Company at any time or from time to time at such redemption price or prices per share, not exceeding \$55 per share, as may be fixed for such series, plus an amount equal to all accrued and unpaid preferential dividends thereon to the date designated for redemption, and upon such other terms and conditions as may be fixed for such series. In the event that at any time less than all the Prior Preferred Stock outstanding is to be redeemed, the shares to be redeemed may be selected pro rata, or by lot, or by such other equitable method as may be determined by the board of directors. Notice of redemption shall be given by the Company by mail-

ing a notice thereof to each holder of record of stock to be redeemed at his last address as the same appears on the books of the Company, such notice to be mailed at least 45 days prior to the date designated for redemption. If such notice of redemption shall have been duly given, and if on or before the redemption date named in such notice all funds necessary for such redemption shall have been set apart by the Company in trust, in a bank or trust company having an aggregate capital and surplus and undivided profits of not less than Two million dollars (\$2,000,000), for the account of the holders of the Prior Preferred Stock to be redeemed, so as to be available therefor, then, from and after the giving of such notice and the setting apart of such funds, notwithstanding that any certificate for shares of Prior Preferred Stock so called for redemption shall not have been surrendered for cancellation, the shares represented thereby shall no longer be deemed outstanding, and the holder of such certificate or certificates shall have with respect to such stock no rights in or with respect to the Company except the right to receive the redemption price thereof and an amount equal to accrued and unpaid preferential dividends thereon to the date designated for redemption, without interest, upon the surrender of such certificate or certificates, and the right, if any, to convert such stock not later than the date designated for redemption to the extent fixed with respect to any series; and after the date designated for redemption such stock

shall not be transferable on the books of the Company except to the Company.

6. Unless preferential dividends on the Prior Preferred Stock are in arrears, the Company shall have the right from time to time to purchase on the open market or at private sale, or otherwise acquire, outstanding Prior Preferred Stock of any series at a price not exceeding the price at which such stock might at the time be redeemed at the option of the Company, plus an amount equal to accrued and unpaid preferential dividends to the date of acquisition or, if such stock is not redeemable, at a price not exceeding the preferential amounts per share payable thereon in the event of voluntary liquidation of the Company as of the date of acquisition.

7. Except as otherwise provided by law or by the provisions of this Article Fourth, each holder of stock of the Company of any class shall be entitled to one vote for all purposes for each share of stock held by him. At all elections of directors each stockholder shall be entitled to as many votes as shall equal the number of his shares of stock multiplied by the number of directors to be elected, or to be elected by the holders of a particular class or classes of stock, as the case may be, and he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them as he may see fit.

8. (a) If at any time preferential dividends on any Prior Preferred Stock shall be in arrears in



an amount equal to four quarterly dividends thereon, the occurrence of such contingency shall mark the beginning of a period which is hereinafter called a "minority representation period," and if at any time such dividends shall be in arrears in an amount equal to twelve quarterly dividends, the occurrence of such contingency shall mark the beginning of a period which is hereinafter called a "majority representation period." Except that the commencement of a majority representation period shall terminate the then preexisting minority representation period, each minority and majority representation period shall extend and continue until there shall have been declared and paid or set apart for payment on all shares of Prior Preferred Stock at the time outstanding all preferential dividends which shall have accrued and be unpaid for all quarterly dividend periods prior to such payment or setting apart for payment as the case may be.

Said minority representation periods and said majority representation periods are together hereinafter sometimes called "default periods." During each default period, the holders of Prior Preferred Stock, voting as a class, irrespective of series, shall have the right to elect the smallest number of directors necessary to constitute (i) during a minority representation period, one-fifth of the board of directors but not less than two directors, and (ii) during a majority representation period, a majority of the board of directors. Such one-fifth (but not less than two) or such majority, as the case may be, are hereinafter sometimes referred to as the "required proportion." The holders of



outstanding junior stock, voting as a class, shall have the right to elect the remaining members of the board of directors.

(b) During any default period such voting right of the holders of Prior Preferred Stock may be exercised initially at a special meeting called pursuant to paragraph (c) of this Section 8 or at any annual meeting of stockholders, and thereafter at meetings of stockholders, provided that neither such voting right nor the right of the holders of Prior Preferred Stock as hereinafter provided to increase in certain cases the authorized number of directors shall be exercised unless a quorum of the holders of Prior Preferred Stock shall be present in person or represented by proxy, which quorum shall consist of the holders of twenty-five per cent (25%) of the number of shares of Prior Preferred Stock outstanding. The absence of a quorum of the holders of junior stock shall not prevent the exercise by the holders of Prior Preferred Stock of such voting right, nor shall the absence of a quorum of the holders of Prior Preferred Stock prevent the exercise by the holders of junior stock of their voting rights as stated in the last sentence of the preceding paragraph (a). If such voting right of the holders of Prior Preferred Stock is exercised initially at a special meeting called pursuant to paragraph (c) of this Section 8, such holders shall have the right, voting as a class, to elect the required proportion of directors, or, during a majority representation period, such additional number as shall be necessary to bring the number of directors

elected by holders of Prior Preferred Stock up to the then required proportion, such election to be effected either by the filling of vacancies, or if there are no vacancies or an inadequate number thereof, by making such increase in the number of directors as shall be necessary, and the election of directors to the offices so created. Any such increase shall not prevent a subsequent increase or decrease in the number of directors by appropriate amendment of the by-laws made, in any manner provided therein, by the board of directors or the holders of Prior Preferred and junior stocks voting irrespective of classes, provided that during a default period no such amendment shall (1) reduce the number of directors elected by the holders of Prior Preferred Stock to less than the required proportion or (2) terminate the office of a director prior to the first annual meeting of stockholders subsequent to his election at which directors are elected, except with the written consent of such director. At no time shall the by-laws be amended so as to be inconsistent with this Section 8.

(c) Unless the holders of Prior Preferred Stock as a class shall, during an existing minority representation period or majority representation period, as the case may be, have previously exercised their right to elect directors, the board of directors may order, or any stockholder or stockholders owning in the aggregate not less than 5% of the total number of shares of Prior Preferred Stock outstanding, irrespective of series, may request, the calling

of a special meeting of the holders of Prior Preferred Stock for the purpose of the initial exercise of the aforesaid voting right of the holders of Prior Preferred Stock during such period, which meeting shall thereupon be called by the President, a Vice-President or the Secretary of the Company. Notice of such meeting shall be mailed within such time as may be required by the by-laws to each holder of record of Prior Preferred Stock at his last address as the same appears on the books of the Company. Such meeting shall be called for a time not earlier than 20 days and not later than 60 days after such order or request; or in default of an issue of call for such meeting within 30 days after such order or request, such meeting may be called on similar notice by any stockholder or stockholders owning in the aggregate not less than 5% of the total number of shares of Prior Preferred Stock outstanding, irrespective of series. Such meeting shall be held at the place then designated by the Company as the place for the holding of its annual stockholders' meetings.

(d) In any default period the holders of Prior Preferred and junior stocks voting irrespective of classes shall continue to be entitled to elect the whole number of directors until the holders of Prior Preferred Stock shall have exercised their right to vote as a class for the election of directors, after the exercise of which right (1) the directors so elected by the holders of Prior Preferred Stock shall continue in office until their successors shall have been elected by such holders or until the ex-



piration of the default period by the declaration and payment or setting apart for payment of the requisite dividends, whichever shall first occur, and (2) any vacancies in the board of directors shall (except as provided in paragraph (b) of this Section 8) be filled only by vote of a majority of the remaining directors theretofore elected by the holders of the class of stock which elected the director whose office shall have become vacant, or if there be only one such director remaining, then by vote of such director. References in this Section 8 to directors elected by the holders of a particular class of stock shall include directors elected by such directors to fill vacancies as provided in clause (2) of the foregoing sentence.

(e) Immediately upon the expiration of a default period by the declaration and payment or setting apart for payment of the requisite dividends, (1) the right of the holders of Prior Preferred Stock to vote as a class in the election of directors shall cease, (2) the term of all directors elected by the holders of Prior Preferred Stock as a class shall terminate, and (3) the number of directors shall be such number as may be provided for in the by-laws irrespective of any increase made pursuant to the provisions of paragraph (b) of this Section 8 (such number being subject, however, to alteration then or thereafter in any manner provided in the by-laws). Any vacancies in the board of directors effected by the provisions of clauses (2) and (3) in the preceding sentence may be filled by the remaining directors.



9. As long as any Prior Preferred Stock is outstanding the Company shall not without the consent of the holders of two-thirds in number of shares of the outstanding Prior Preferred Stock, irrespective of series except as otherwise in this Section 9 provided, given in person or by proxy at a meeting of stockholders called for that purpose, or given in writing:

(a) amend or repeal any provision of, or add any provision to, the Certificate of Incorporation of the Company, if such action would alter or change the preferences, special rights or powers of the Prior Preferred Stock so as to affect such Prior Preferred Stock adversely; or

(b) increase the authorized amount of the Prior Preferred Stock, or authorize or create any class of stock of the Company having any preference or priority as to dividends or assets superior to or on a parity with any such preference or priority of the Prior Preferred Stock, or authorized or create any stock, security, debt or obligation convertible into any stock of the Company having any such preference, priority or equality; or

(c) reclassify outstanding shares of stock of any class ranking after the Prior Preferred Stock as to dividends or assets into shares of stock of any class ranking on a parity with or having any preference over the Prior Preferred Stock as to dividends or assets; or

(d) by voluntary action dissolve, liquidate, or wind up the Company, or sell or dispose of sub-

stantially all of the assets of the Company, or effect the merger or consolidation of the Company into or with any corporation; provided, however, that nothing in this paragraph (d) shall prevent, or require the consent of the holders of any proportion of the shares of Prior Preferred Stock, as a class, to, (i) the merger or consolidation of the Company into or with a corporation organized under the laws of the State of California, provided that such corporation shall upon the completion of such merger or consolidation, succeed or have succeeded to the ownership of the business and assets owned by the Company immediately prior to such merger or consolidation, and have outstanding a structure of liabilities, capital stock and surplus substantially similar to the structure of the Company immediately prior to such merger or consolidation, and the holders of Prior Preferred Stock of each series shall thereafter have, or shall be offered in exchange, stock having in all material respects the same powers, preferences and rights to which shares of Prior Preferred Stock of such series were entitled immediately prior to such merger or consolidation; or (ii) the merger into the Company of any subsidiary company or companies in which the Company owns or controls, directly or indirectly, more than ninety per cent (90%) of the outstanding stock entitled (at the time immediately preceding such merger) to vote for directors if such merger shall not affect the preferences, special rights or powers of the Prior Preferred Stock so as to affect such Prior Preferred Stock adversely; or

(e) declare or pay any dividends on junior stock out of capital surplus; or distribute capital to, or purchase, redeem or otherwise acquire, any junior stock of the Company, except in exchange for, or by conversion into, or with the proceeds of, junior stock issued after this amendment to this Article Fourth becomes effective; or

(f) declare any dividend on any junior stock of the Company if, or if thereupon, the earned surplus of the Company available for dividends, (as determined in accordance with sound accounting practice and in accordance with any applicable system of accounts prescribed by governmental authorities) would be less than an amount equal to two (2) years' dividend requirements on the Prior Preferred Stock at the time outstanding; provided, however, that nothing in this paragraph (f) shall prevent the declaration or payment of any cumulative preferred dividends on the Company's \$3 Cumulative Preferred Stock accruing during the period from the effective date of this amendment to June 30, 1943, if such declaration or payment complies with the provisions of Sections 2 and 3 of this Subdivision I; or

(g) issue, sell or otherwise dispose of:

(i) any shares of Prior Preferred Stock except an initial issue of 60,000 shares thereof, or

(ii) any shares of any other class of stock ranking prior to or on a parity with the Prior Preferred Stock as to dividends or assets,

unless the net income of the Company determined



in accordance with generally accepted accounting practice to be available for the payment of dividends for a period of twelve consecutive calendar months within the fifteen calendar months immediately preceding the issuance, sale or disposition of such stock, is at least equal to three and one-half times the annual dividend requirements on all outstanding shares of Prior Preferred Stock and of all other classes of stock ranking prior to or on a parity with the Prior Preferred Stock as to dividends or assets, including the shares proposed to be issued, and unless the income of the Company for said period, determined in accordance with such generally accepted accounting practice (but in any event after deducting all taxes and the amount for said period charged by the Company on its books to depreciation expense) to be available for the payment of interest, shall have been at least one and three-fourths times the sum of (i) the annual interest charges on all interest bearing indebtedness of the Company which will be outstanding immediately after the issuance of such stock proposed to be issued and (ii) the annual preferred dividend requirements on all outstanding shares of Prior Preferred Stock and of all other classes of stock ranking prior to or on a parity with the Prior Preferred Stock as to dividends or assets, including the shares proposed to be issued, provided, however, that in the event the Company shall have acquired any electric plant or system within or after the particular period for which the calculation of the earnings of the Company is made, or shall ac-



quire such plant or system simultaneously with the issuance of such stock, then, in computing such earnings there shall be included, to the extent that they may not have been otherwise included, the net earnings or net losses of, and charges applicable to, such acquired plant or system for the whole of such period, such net earnings or net losses and charges to be ascertained and computed as if such acquired plant or system had been owned by the Company during the whole of such period.

Provided, however, that:

(i) If any action described in the foregoing paragraph (a) would affect adversely Prior Preferred Stock of less than all series, such action shall require the consent of the holders of two-thirds (2/3ds) in number of shares of the outstanding Prior Preferred Stock of such series only as may be so affected, acting as a class, given as aforesaid;

(ii) Any action specified in this Section 9 as requiring such consent of the holders of Prior Preferred Stock, irrespective of series, or of the holders of Prior Preferred Stock of less than all series, as the case may be, may, unless provided otherwise by statute, be taken with such consent, and with such additional vote or consent, if any, of holders of junior stock, or of a particular class or classes of junior stock, as from time to time may be required by law.

## Subdivision II. \$3 Cumulative Preferred Stock

1. For the purposes of this Subdivision II of

this Article Fourth the following terms shall have the following meanings unless the context shall otherwise require:

(a) the term “this amendment” means this amendment to this Article Fourth of the Certificate of Incorporation of the Company. References to this amendment becoming “effective” (or to the “effective date” thereof) shall refer to the filing (or date of filing) for recording in the office of the Recorder of New Castle County, Delaware, of a copy of the applicable Certificate of Amendment, certified by the Secretary of State of the State of Delaware.

(b) the term “\$3 Preferred Stock” means the \$3 Cumulative Preferred Stock of the par value of \$50 per share authorized by this amendment.

(c) the term “old Preferred Stock” means the Preferred Stock of the Company of the par value of \$100 per share outstanding immediately prior to this amendment becoming effective.

2. Upon this amendment becoming effective each share of old Preferred Stock shall by virtue of this amendment be automatically reclassified and converted into (a) four-fifths ( $4/5$ ths) of one share of \$3 Preferred Stock, and (b) six shares of Common Stock. The remaining shares of \$3 Preferred Stock authorized by this amendment may be issued by the Company from time to time for such consideration, not less than the par value thereof, as may be fixed from time to time by the board of directors.

3. Subject to the applicable provisions of Subdivision I of this Article Fourth and to the applicable provisions of any resolution of the board of directors lawfully adopted pursuant to the provisions of Section 1 of said Subdivision I, the designations, powers, preferences and relative and other special rights, and the qualifications, limitations and restrictions thereof, of the \$3 Preferred Stock shall be as set forth in this Subdivision II.

4. Subject to compliance with the provisions of Sections 2 and 3 and paragraphs (e) and (f) of Section 9 of Subdivision I, the holders of shares of \$3 Preferred Stock shall be entitled to receive, when and as declared by the board of directors, out of any funds or assets legally available for that purpose, preferential cumulative dividends in cash as follows:

(a) in the case of each share of \$3 Preferred Stock issued upon the reclassification and conversion of one and one-fourth ( $1\frac{1}{4}$ ) share of old Preferred Stock as required in Section 2 of this Subdivision II, an amount equal to the aggregate of:

(i) the unpaid portion of the cumulative preferred dividends which shall have accrued on each one and one-fourth ( $1\frac{1}{4}$ ) share of such old Preferred Stock from the date of accrual to the effective date of this amendment; and

(ii) cumulative preferential dividends at the rate of Three Dollars (\$3) per share per annum on the \$3 Preferred Stock from and after the effective date of this amendment; and



(b) in the case of all other shares of \$3 Preferred Stock, cumulative preferential dividends at the rate of Three Dollars (\$3) per share per annum, which dividends shall accrue from the first day of the quarter in which such shares are issued.

Each share of \$3 Preferred Stock shall rank on a parity with each other share of \$3 Preferred Stock with respect to current preferential dividends. The preferential cumulative dividends which accrue on the \$3 Preferred Stock after the effective date of this amendment shall be payable quarterly for the quarters ending on the last days of March, June, September and December in each year. The holders of shares of \$3 Preferred Stock shall not be entitled to receive any dividends over and above such preferential cumulative dividends as hereinbefore provided for, and such dividends shall not bear interest. Such preferential cumulative dividends shall be declared and paid or set apart for payment in full for all previous quarterly dividend periods before the declaration of payment of or setting apart for payment of any dividends on, or the making of or setting apart of any funds or assets for any distribution with respect to any Common Stock, and before or concurrently with any purchase or other acquisition of any Common Stock, or the setting apart of any funds or assets for such purchase or acquisition. At any time after cumulative preferred dividends on the \$3 Preferred Stock for all previous quarterly dividend periods (including, without limitation, preferred dividends



accruing prior to the effective date of this amendment) shall have been declared and paid or set apart for payment, the board of directors may, after or concurrently with, but not before, the declaration of full preferential dividends on the \$3 Preferred Stock for the current quarterly dividend period, and also subject to compliance with the provisions of Sections 2 and 3 and paragraphs (e) and (f) of Section 9 of Subdivision I, declare dividends (payable in cash, property or stock) on outstanding shares of Common Stock out of any assets legally available for that purpose; provided, however, that no dividends on any Common Stock shall be paid, set apart for payment, or be payable, before full preferential dividends shall have been paid or set apart for payment on the \$3 Preferred Stock for the quarterly dividend period for which such dividend on Common Stock shall have been declared.

5. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Company or any distribution of the capital of the Company, the holders of \$3 Preferred Stock shall be entitled to receive from the assets of the Company available for distribution to the holders of stock junior to the Prior Preferred Stock, and whether represented by capital, surplus, reserves or earnings, a preferential amount in cash equal to the par value of such shares of \$3 Preferred Stock together with a further preferential amount in cash equal to all accrued and unpaid cumulative preferential dividends thereon to the date payment is made

available to the \$3 Preferred Stockholders; all of which shall be paid or set apart for payment before or concurrently with the payment of or setting apart for payment of any amount for, or the distribution of any assets of the Company to, the holders of any Common Stock. Each share of \$3 Preferred Stock shall, on the basis of the par value thereof plus all unpaid accrued dividends thereon, rank on a parity with each other share of \$3 Preferred Stock (on the basis of the par value thereof plus all unpaid accrued dividends thereon) with respect to the preferential amounts payable on any distribution of assets by way of liquidation, dissolution or winding up of the Company and no such amount shall be paid or set apart for payment on any shares of \$3 Preferred Stock unless at the same time amounts in like proportion to the respective preferential amounts to which each other share is entitled, shall be paid or set apart for payment on each other share then outstanding. After payment or the setting apart for payment to the holders of the Prior Preferred Stock and the holders of \$3 Preferred Stock of the preferential amounts so payable to them, all the remaining assets of the Company shall belong to and be distributable pro rata to the holders of Common Stock.

6. The voting rights of holders of \$3 Preferred Stock and of Common Stock shall be as set forth in Sections 7 and 8 of Subdivision I of this Article Fourth.

## Subdivision III. Common Stock

Each share of Common Stock of the par value of \$10 per share outstanding at the time this amendment becomes effective shall continue to be a share of Common Stock of the par value of \$10 per share. Additional shares of authorized Common Stock, in the requisite number, shall be issued to effect the reclassification and conversion of old Preferred Stock pursuant to Section 2 of Subdivision II. The remaining number of shares of Common Stock authorized by this amendment may be issued by the Company from time to time for such consideration, not less than the par value thereof, as may be fixed from time to time by the Board of Directors.

## Subdivision IV. Denial of Preemptive Right

No holder of any shares of any class of stock of the Company shall be entitled as of right to subscribe for, purchase or receive any shares of Prior Preferred Stock or of \$3 Preferred Stock issued by the Company (including shares of Prior Preferred Stock which are convertible into or exchangeable for one or more classes of junior stock). Except to the extent that the holders of Prior Preferred Stock of any series may be granted the optional privilege of converting such stock into, or exchanging such stock for, one or more classes of junior stock, such conversion or exchange privilege being stated and expressed in the resolution or resolutions providing for the issue of such Prior Preferred Stock of such series adopted by the board



of directors, no holder of any Prior Preferred Stock issued by the Company, as such holder, shall be entitled as of right to subscribe for, purchase or receive any shares of stock of any class issued by the Company. No holder of any \$3 Preferred Stock of the Company, as such holder, shall be entitled as of right to subscribe for, purchase or receive any shares of stock of any class issued by the Company. No holder of any class of stock of the Company, as such holder, shall be entitled as of right to subscribe for, purchase or receive any shares of Common Stock issued upon the reclassification and conversion of old Preferred Stock pursuant to the provisions of Section 2 of Subdivision II or issuable upon the exercise by the holder of shares of Prior Preferred Stock of any series of any optional conversion or exchange privilege stated and expressed in the resolution or resolutions adopted by the board of directors providing for the issue of Prior Preferred Stock of such series.

#### IV.

To strike out the eleventh paragraph of Article Eighth of the Certificate of Incorporation as heretofore amended, which paragraph now reads as follows:

This Corporation reserves the right to amend, alter, change, or repeal any provision contained in this Certificate of Incorporation, in the manner now or hereafter prescribed by the statutes of the State of Delaware, and also the right to reorganize and



reincorporate under the laws of any other state, and all rights conferred on officers, Directors, and stockholders, are granted subject to these reservations. and to insert in lieu thereof the following:

Subject to compliance with the applicable provisions of Section 9 of Subdivision I of Article Fourth, this Corporation reserves the right to amend, alter, change, or repeal any provision contained in this Certificate of Incorporation, in the manner now or hereafter prescribed by the statutes of the State of Delaware, and also the right to reorganize and reincorporate under the laws of any other state, and all rights conferred on officers, Directors, and stockholders, are granted subject to these reservations.

I, L. G. Peck, Assistant Secretary of California Electric Power Company, do hereby certify that the above is a full, true and correct copy of amendment to the Certificate of Incorporation of The Nevada-California Electric Corporation (Name changed June 30, 1941, to California Electric Power Company) adopted at a meeting of stockholders of said corporation held June 20, 1941.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said Company this 4th day of August, 1949.

[Seal]      /s/ L. G. PECK,

Assistant Secretary.

## Exhibit B

Certified Copy of Resolution Adopted by Board  
of Directors of The Nevada-California Elec-  
tric Corporation

(Name Changed June 30, 1941 to California Elec-  
tric Power Company) at a Meeting Held  
May 29, 1941.

Resolved, that, at such time as the President may deem advisable, the Corporation shall make an offer to the holders of the existing preferred stock, for acceptance within 20 days of the making of such offer or within such extended period as the Board may direct, to issue one-fifth of a share of \$3 preferred stock and to pay one dollar in cash to the holder of each share of existing preferred stock who shall accept such stock and such payment in full settlement of the right of such holder to all cumulative preferred dividend arrearages which shall have accrued on such existing preferred stock to and including June 30, 1941, provided that the consummation of such settlement of said arrears and the issuance of said \$3 preferred stock and the payment of said cash shall be contingent upon the amendments to the Certificate of Incorporation of the Corporation which have this day been declared advisable by the Board of Directors becoming effective under the laws of the State of Delaware, and further

Resolved, that in the event that such amendments become effective the proper officers of the Corpora-

tion shall be authorized to execute and deliver stock certificates representing the shares of \$3 preferred stock issuable upon such settlement, either separate from or in conjunction with the issuance of shares of \$3 preferred stock issued pursuant to the reclassification provisions of such amendments.

\* \* \*

I, L. G. Peck, Assistant Secretary of California Electric Power Company, do hereby certify that the foregoing is a full, true and correct copy of a resolution adopted by the Board of Directors of The Nevada-California Electric Corporation at a meeting of said Board duly held on the 29th day of May, 1941, a quorum of said Board being present.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said Company this 4th day of August, 1949.

[Seal]      /s/ L. G. PECK,

Assistant Secretary.

[Endorsed]: Filed December 5, 1949.

In the District Court of the United States South-  
ern District of California, Central Division

No. 7888-BH

CALIFORNIA ELECTRIC POWER COM-  
PANY, a corporation,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

### OPINION

#### Appearances:

DEMPSEY, THAYER, DEIBERT &  
KUMLER, Esqs.

1104 Pacific Mutual Building  
Los Angeles 14, California,  
Attorneys for Plaintiff,

ERNEST A. TOLIN, Esq.,  
United States Attorney,

E. H. MITCHELL, and  
EDWARD R. McHALE, Esqs.,  
Assistant United States Attorneys,

EUGENE HARPOLE and  
JAMES D. PETTUS, Esqs.,  
Special Attorneys, Bureau of Internal  
Revenue,  
Attorneys for Defendant.

U. S. Post Office and Court House  
Los Angeles 12, California,

This is an action to recover the sum of \$4,549.51,



alleged to have been erroneously exacted from the plaintiff, under Section 1802(a) of the Internal Revenue Code, Title 26, U.S.C.A., prior to the amendment of 1947, as a documentary stamp tax upon a certain issue of stock by plaintiff. The question for decision is whether the entire issue or only a part thereof of plaintiff's new preferred stock constituted an original issue within the meaning of Section 1802(a). The facts were stipulated and are substantially as follows:

Prior to the time of the recapitalization in June of 1941, plaintiff's capital stock consisted of 105,023 preferred shares, each having a par value of \$100.00, and 84,683 common shares, each having a value of \$10.00. The stamp tax due on this stock had been paid. On June 20, 1941, the certificate of incorporation was amended to provide that each of the outstanding shares of old preferred stock were to be automatically converted into  $\frac{4}{5}$  share of \$3.00 cumulative preferred stock of a par value of \$50.00 each, and six shares of common stock of a par value of \$10.00 each. This amendment was to be effective June 30, 1941. This change did not affect the proportionate interests of the shareholders in the corporation's assets. By itself this transaction would have been free of any stamp tax.

However, on June 30, 1941, the effective date of the amendment, the unpaid cumulative dividends on the old preferred stock were \$11.00 per share. To settle the arrearages of dividends the Board of Directors had previously, by resolution, on May

29, 1941, authorized the making of an offer to the preferred shareholders of  $1/5$  share of \$3.00 cumulative preferred stock and \$1.00 in cash in full settlement of all arrearages on each share. The offer was to remain open until June 25, 1941, and was contingent on the amendment of the certificate of incorporation by the shareholders.

Pursuant to the plan for settlement of the dividend arrearages plaintiff issued new \$3.00 stock on a one new for five old basis to the shareholders accepting the offer. Upon completion of the exchange, new capital sufficient to pay the dividend arrearages was transferred from surplus to the preferred stock account, so that the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividends into additional shares of stock representing capitalized surplus.

Stated simply for the purposes of illustration, the two transactions may be compared as follows: If shareholder A had 50 shares of the original preferred stock, following the amendment he now has 40 shares of the new preferred stock. If he accepts the offer of stock for dividend arrearages he receives ten additional shares of the new preferred stock and \$50.00 in cash. At the same time there is a transfer from surplus to the capital stock account of an amount equal to the share value of the 10 additional shares.

If shareholder B had 50 shares of the original preferred stock, following the amendment he also

now has 40 shares of the new preferred shares. If he does not accept the offer of the stock for the dividend arrearages he, of course, receives no additional shares and there is no transfer of any surplus to the preferred stock account. As to shareholder B, there has been no change except an exchange of old preferred shares for new preferred shares. His proportionate claim against the corporation's assets remains unchanged.

The plaintiff admits that the shares issued in satisfaction of the unpaid dividends were within the meaning of the term "original issue" and concedes the tax upon them.

The Commissioner conceded that no tax was due upon the new issue of the common stock but determined that the transfer of the surplus to the preferred stock account resulted in the dedication of additional capital; that this represented capital upon which no previous issue tax had ever been paid; and that the old capital and the new capital were so intermingled that it is impossible to determine which specific shares are represented by new capital added to the preferred stock account.

The tax was paid under protest and the claim for refund was denied.

The applicable statute at the time of the issue, Section 1802(a), imposed a stamp tax on the original issues of capital stock. The tax applies to each original issue (whether on organization or reorganization) of certificates (or shares issued without certificate) of stock, or of profits, or of



interests in property or accumulations by any corporation.

The government contends that the entries upon the corporate books fail to disclose any shares specifically designated as a substitution for old certificates. It suggests that inasmuch as no shares were issued in lieu of any certain specified shares and no specific certificates charged against any particular segment of the capital or surplus, it is impossible to classify the entire issue as other than original. This is the same argument advanced in *U. S. v. Pure Oil Co.*, 135 F. (2d) 578, a decision of the 7th Circuit on substantially the same facts as we have in the instant case.

The court in *U. S. v. Pure Oil Co.*, *supra*, refused to adopt this contention. Speaking of the issue of stock by the Pure Oil Company the court stated:

“\* \* \* It accomplished nothing other than replacement of older preferred stock with new, smaller dividend stock; the holders retained the same proportionate interests in the capital assets. The additional shares issued in satisfaction of unpaid dividends represented the only contribution to capital effectuated; that and that alone was an original issue, (citing numerous cases) (underscoring supplied).

“\* \* \* The undisputed fact is that the old preferred stock was exchanged share for share and the dividend arrears satisfied by issuance of additional shares. Whatever the book en-



tries, the only new thing that could properly have gone into the capital account was the contribution by the shareholders of their unpaid dividends to the corporation in consideration of which they received the additional shares.”

The government criticises this decision, at the same time it did not endeavor to justify its attempted exaction of over \$20,000.00 by applying for a writ of certiorari. It is interesting to note that Circuit Judge Minton, now a member of the Supreme Court of the United States concurred in said opinion.

The government cites *American Gas & Electric Co. v. U. S.* 69 F. Supp. 614 (D.C., N.Y.) in support of its contention that the two issues were so intermingled that they must be treated as one. This decision is not critical of the *Pure Oil* case as contended by the government. Judge Caffey clearly distinguished the two cases on the facts and I think attempted to justify his conclusions by stating on page 620 as follows:

“\* \* \* Apparent hardship to the taxpayer does not justify a departure from the literal language of the statute.”

The government urges two decisions of the Ninth Circuit as authority for its position in this case, *Rio Grande Oil Co. v. Welch*, 101 F. 2d 454, and *Southern Pacific Co. v. Berliner* 176 F. 2d 671. Both of these cases are clearly distinguished from

the present case on the facts. In the Southern Pacific case Judge Healy did not mention the Pure Oil case, which indicates he recognized that factually they were not comparable. The failure to refer to it was intentional as it was cited on another point in the opinion written by Judge Roche in the District Court in *Southern Pacific Co. v. Berliner*, 78 F. Supp. 696-697.

The authorities cited by the government in support of its interpretation of the statute created serious inequities. Congress, recognizing the inequities created by the interpretation placed upon the statute by the Commissioner, supported by the courts, put a stop to the same by the amendment of 1947. While the amendment is not retroactive, it clearly indicates that the interpretation of the former act did not meet the approval of Congress. Under such circumstances, I see no reason why I should meekly submit to the Commissioner's rulings thereby helping to perpetuate an inequity that Congress has already recognized and precluded its repetition in the future.

From the stipulation of facts I find that the two transactions were sufficiently separate and apart to permit the necessary allocation. The method of keeping the records is not controlling (*So. Pac. Co. v. Berliner*, 176 F. 2d 671). In a transaction such as we have in this case, there is no apparent difficulty in allocating the increase in capital to the shares issued in lieu of dividends. The Pure Oil case is very persuasive and also very refreshing and I am accepting it as my guide in this case.

Plaintiff is entitled to judgment as prayed for. Counsel for the plaintiff is directed to submit proposed finding and judgment within fifteen days from date hereof.

Dated: This 16th day of March, 1950.

/s/ BEN HARRISON,  
Judge.

[Endorsed]: Filed March 16, 1950.

---

[Title of District Court and Cause.]

## FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above-entitled cause was submitted to the Court for decision on December 5, 1949, by Plaintiff's attorney, Arthur H. Deibert, and Defendant's attorney, Eugene Harpole, on a stipulation of facts, briefs were filed by each of the parties and the Court having fully considered the same hereby makes the following special Findings of Fact:

### Findings of Fact

#### I.

That California Electric Power Company (formerly named The Nevada-California Electric Corporation) is a corporation duly organized and existing under and by virtue of the laws of the State of Delaware, duly licensed to engage in business in the State of California; that California



Electric Power Company's principal office is located at 3771 Eighth Street, City of Riverside, County of Riverside, State of California, and in the Southern Judicial District of California, Central Division.

## II.

That the documentary stamp taxes here involved, in the amount of \$4,549.51, were paid on or about January 28, 1942, by the California Electric Power Company to Ralph Nicholas, the duly appointed, qualified and acting Collector of Internal Revenue for the collection district comprising the State of Colorado.

## III.

That prior to recapitalization on June 30, 1941 the Plaintiff's capital stock consisted of 105,023 preferred shares having a par value of \$100.00 per share, and 84,683 common shares having a par value of \$10.00 per share. The stamp tax on this stock had been paid.

## IV.

That on June 20, 1941, Plaintiff's certificate of incorporation was amended to provide that each of the outstanding shares of old preferred stock were to be automatically converted into  $\frac{4}{5}$  share of \$3.00 cumulative preferred stock of a par value of \$50.00 each, and six shares of common stock of a par value of \$10.00 each. This amendment was to be and became effective June 30, 1941. This change did not affect the proportionate interests of the shareholders in the corporation's assets.



## V.

That the Commissioner of Internal Revenue has conceded that no stamp tax is due by virtue of the issuance of the aforesaid new common stock.

## VI.

That on June 30, 1941, unpaid Cumulative Preferred dividends on the old Preferred Stock of California Electric Power Company amounted to \$11.00 per share.

## VII.

That in order to settle the arrearages of dividends the Board of Directors had previously, by resolution, on May 29, 1941, authorized the making of an offer to the preferred shareholders of  $1/5$  share of \$3.00 cumulative preferred stock and \$1.00 cash in full settlement of all arrearages on each share. The offer was to remain open until June 25, 1941, and was contingent on the amendment of the certificate of incorporation by the shareholders.

## VIII.

That pursuant to the plan for settlement of the dividend arrearages Plaintiff issued new \$3.00 stock on a one new for five old basis to the shareholders accepting the offer. Upon completion of the exchange, new capital sufficient to pay the dividend arrearages was transferred from surplus to the preferred stock account, so that the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividends into

additional shares of stock representing capitalized surplus.

IX.

That the number of shares of new Preferred Stock at \$50.00 per share issued up to January 24, 1942 was 103,398.

X.

That the Plaintiff concedes liability and has paid the stamp tax due upon the shares issued in settlement of dividend arrearages.

XI.

That the Commissioner determined that the transfer of the surplus to the preferred stock account resulted in the dedication of additional capital; that this represented capital upon which no previous issue tax had ever been paid; and that the old capital and the new capital were so intermingled that it is impossible to determine which specific shares are represented by new capital added to the preferred stock account.

XII.

That Plaintiff, pursuant to the aforesaid ruling of the Commissioner, paid the sum of \$4,549.51 here in question under protest. This sum represents the difference between the amount conceded to be due by Plaintiff on stock issued in settlement of dividend arrearages and that asserted by the Commissioner upon the entire issue of new preferred stock up to January 24, 1942.

XIII.

That on or about January 24, 1946, California Electric Power Company filed with the Collector of Internal Revenue at Denver, Colorado, a Claim for Refund of stamp taxes paid in the amount of \$4,549.51, together with interest thereon as provided by law.

XIV.

That the Commissioner of Internal Revenue, by letter dated June 16, 1947, rejected said Claim for Refund filed on or about January 24, 1946, as aforesaid.

From these facts, the Court concludes:

Conclusions of Law

I.

That the failure of the Plaintiff to issue specific shares in lieu of certain specified shares or the failure to charge specific shares against any particular segment of capital or surplus does not necessarily make the entire issue of stock an original issue. Book entires alone are not decisive.

II.

The issuance of new preferred stock in partial satisfaction of dividend arrearages was a sufficiently separate and distinct transaction from the exchange of new preferred stock for old as to allow an allocation to be made between the new capital thereby added and the old capital for which the exchange was made.

## III.

The only new capital which was dedicated by these transactions was that attributable to the issuance of new preferred stock in partial settlement of dividend arrearages and the shares so issued constituted the only original issue of stock within the meaning of Section 1802(a) Internal Revenue Code as it existed prior to January 24, 1942.

## IV.

The issuance of new preferred stock in exchange for old preferred stock did not constitute an "original issue" of stock within the meaning of Section 1802(a) of the Internal Revenue Code as it existed prior to January 24, 1942, and that no tax was therefore due upon the issuance thereof.

## V.

Plaintiff is entitled to judgment as prayed.

Dated: April 17, 1950.

/s/ BEN HARRISON,  
Judge.

Approved as to Form:

/s/ EUGENE HARPOLE,  
Special Attorney,  
Bureau of Internal  
Revenue.

[Endorsed]: Filed April 17, 1950.



In the District Court of the United States, Southern District of California, Central Division

N. 7888-BH

CALIFORNIA ELECTRIC POWER COMPANY, a Corporation,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

### JUDGMENT

The above-entitled cause came before the Court sitting without a jury on December 5, 1949. Plaintiff was present in Court and represented by its Counsel, Arthur H. Deibert, and Defendant was present in Court and represented by its Counsel, Eugene Harpole. The cause was thereupon submitted to the Court upon a stipulation of facts signed by attorneys for the parties hereto. Briefs were filed on behalf of the parties hereto. Thereafter, the Court, having fully considered the facts and the briefs and being fully advised in the premises, ordered preparation of its findings of fact and conclusions of law and judgment.

Wherefore, by reason of the law and the evidence and the findings of fact and conclusions of law of the Court which have been filed and the premises aforesaid,

It Is Ordered, Adjudged and Decreed, and this does order, adjudge and decree that the Plaintiff

have judgment against and have and recover of and from the Defendant named above the sum of \$4,549.51, plus interest thereon from January 28, 1492, until paid.

Done and dated at Los Angeles, California, this 17th day of April, 1950.

/s/ BEN HARRISON,

United States District Judge.

Approved as to Form:

/s/ EUGENE HARPOLE,

Special Attorney,

Bureau of Internal

Revenue.

Judgment entered April 17, 1950.

[Endorsed]: Filed April 17, 1950.

[Title of District Court and Cause.]

## NOTICE OF APPEAL

Notice is hereby given that the United States of America, the above-named defendant, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on May 17, 1950.

Dated: June 12, 1950.

/s/ ERNEST A. TOLIN,  
United States Attorney.

By /s/ E. H. MITCHELL,  
Assistant United States  
Attorney.

Receipt of copy acknowledged.

[Endorsed]: Filed June 14, 1950.

---

[Title of District Court and Cause.]

## STATEMENT OF POINTS UPON WHICH DEFENDANT (AS APPELLANT) IN- TENDS TO RELY ON APPEAL

The defendant, upon its appeal from the judgment entered in the above cause on April 17, 1950, intends to rely upon the following points:

1. The Court erred by concluding that, in the conversion of plaintiff's outstanding preferred

stock to new preferred stock, the issuance of the new preferred in partial satisfaction of dividend arrearage was sufficiently separate and distinct from the exchange of new preferred stock from the old preferred stock as to allow an allocation to be made between the new and the old capital.

2. The Court erred by failing to conclude that the new capital, consisting of dividend arrearages, was added to and commingled with the old capital of the preferred capital stock account so that the added capital could not be identified with specific shares of the new preferred stock and, therefore, an original issue tax was incurred as to 103,398 shares of the new preferred stock.

3. The Court erred by having judgment entered for the plaintiff.

Dated June 12, 1950.

/s/ ERNEST A. TOLIN,  
United States Attorney.

By /s/ E. H. MITCHELL,  
Assistant United States  
Attorney.

Receipt of copy acknowledged.

[Endorsed]: Filed June 14, 1950.



[Title of District Court and Cause.]

## DESIGNATION OF RECORD ON APPEAL

Comes now the above-named defendant and hereby designates the portions of the record and proceedings to be contained in the record on appeal herein:

The defendant designates the entire record herein, including the Complaint, the Answer, the Stipulation of Facts, including the exhibits attached thereto and made a part thereof, the Decision of the Court, the Court's Findings of Fact and Conclusions of Law and the Judgment as entered.

Dated this 12th day of June, 1950.

/s/ ERNEST A. TOLIN,  
United States Attorney.

By /s/ E. H. Mitchell,  
Assistant United States  
Attorney.

Receipt of copy acknowledged.

[Endorsed]: Filed June 14, 1950.

---

[Title of District Court and Cause.]

## CERTIFICATE OF CLERK

I, Edmund L. Smith, Clerk of the United States

District Court for the Southern District of California, do hereby certify that the foregoing pages numbered from 1 to 69, inclusive, contain the original Complaint; Answer; Stipulation of Facts; Opinion; Findings of Fact and Conclusions of Law; Judgment; Notice of Appeal; Statement of Points Upon Which Appellant Intends to Rely on Appeal and Designation of Record on Appeal which constitute the record on appeal to the United States Court of Appeals for the Ninth Circuit.

Witness my hand and the seal of said District Court this 12th day of July, A.D. 1950.

EDMUND L. SMITH,

Clerk.

[Seal] By /s/ THURMON HOCKE,

Chief Deputy.

---

[Endorsed]: No. 12611. United States Court of Appeals, for the Ninth Circuit. United States of America, Appellant, vs. California Electric Power Company, a corporation, Appellee. Transcript of Record. Appeal from the United States District Court for the Southern District of California, Central Division.

Filed July 14, 1950.

/s/ PAUL P. O'BRIEN,

Clerk of the United States Court of Appeals for the Ninth Circuit.

In The United States Court of Appeals  
for the Ninth Circuit

Undocketed

UNITED STATES OF AMERICA,

Appellant,

vs.

CALIFORNIA ELECTRIC POWER COM-  
PANY, a Corporation,

Appellee.

APPELLANT'S STATEMENT OF POINTS  
TO BE RELIED UPON ON APPEAL

Pursuant to the provisions of Rule 19(6) of the Rules of Practice of the United States Court of Appeals for the Ninth Circuit, Appellant hereby designates the following points upon which it intends to rely in its appeal in the above-entitled case:

1. The Court erred by concluding that, in the conversion of Plaintiff-Appellee's outstanding preferred stock to new preferred stock, the issuance of the new preferred in partial satisfaction of dividend arrearage was sufficiently separate and distinct from the exchange of new preferred stock from the old preferred stock as to allow an allocation to be made between the new and the old capital.

2. The Court erred by failing to conclude that

the new capital, consisting of dividend arrearages, was added to and commingled with the old capital of the preferred capital stock account so that the added capital could not be identified with specific shares of the new preferred stock and, therefore, an original issue tax was incurred as to 103,398 shares of the new preferred stock.

3. The Court erred by having judgment entered for the Plaintiff-Appellee.

Dated: This 10th day of July, 1950.

ERNEST A. TOLIN,  
United States Attorney.

E. H. MITCHELL, and  
EDWARD R. McHALE,  
Assistant United States  
Attorneys.

EUGENE HARPOLE, and  
FRANK W. MAHONEY,  
Special Attorneys,  
Bureau of Internal  
Revenue.

By /s/ EUGENE HARPOLE,  
Attorneys for Appellant,  
United States of America.

Receipt of copy acknowledged.

[Endorsed]: Filed July 14, 1950.



[Title of Court of Appeals and Cause.]

APPELLANT'S DESIGNATION OF PARTS  
OF RECORD BELIEVED NECESSARY  
FOR CONSIDERATION ON APPEAL AND  
TO BE PRINTED

Pursuant to Rule 19(6) of this Court, Appellant hereby designates the following parts of the record as being necessary for consideration of the points upon which it intends to rely in this appeal, and which it desires to have printed, omitting the title of Court and cause from each of the documents designated for printing:

Pages of Certified Record

1. Page 1—Names and addresses of attorneys.
2. Pages 2 to 19, inclusive—Complaint.
3. Pages 21, 22—Answer.
4. Pages 23 to 39, inclusive—Stipulation of Facts, but omitting pages 40 to 50, inclusive, which duplicate pages 8 to 19, inclusive, of the record.
5. Pages 52 to 57, inclusive—Opinion.
6. Pages 58 to 62, inclusive—Findings of Fact and Conclusions of Law.
7. Pages 63 and 64—Judgment.
8. Page 65—Notice of Appeal.
9. Pages 66 and 67—Statement of Points to be Relied Upon on Appeal (District Court).

10. Page 68—Designation of Contents of Record on Appeal (District Court).

11. This Designation.

12. Appellant's Statement of Points to be Relied Upon (Circuit Court).

Certificate of Clerk.

Dated: This 10th day of July, 1950.

ERNEST A. TOLIN,  
United States Attorney.

E. H. MITCHELL, and  
EDWARD R. McHALE,  
Assistant United States  
Attorneys.

EUGENE HARPOLE, and  
FRANK W. MAHONEY,  
Special Attorneys,  
Bureau of Internal  
Revenue.

By /s/ EUGENE HARPOLE,  
Attorneys for Appellant,  
United States of America.

Receipt of copy acknowledged.

[Endorsed]: Filed July 14, 1950.

No. 12611

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

UNITED STATES OF AMERICA,

*Appellant,*

*vs.*

CALIFORNIA ELECTRIC POWER COMPANY, a corporation,

*Appellee.*

---

Upon Appeal From the District Court of the United States  
for the Southern District of California,

---

## BRIEF FOR THE UNITED STATES.

---

THERON LAMAR CAUDLE,

*Assistant Attorney General,*

ELLIS N. SLACK,

A. F. PRESCOTT,

MARYHELEN WIGLE,

*Special Assistants to the Attorney General,*

ERNEST A. TOLIN,

*United States Attorney,*

E. H. MITCHELL,

*Assistant United States Attorney.*

600 United States Post Office and Court House, P. O. BOX 1000,

Building, Los Angeles 12, California.

FILED

MAY - 6 1950

CLERK





## TOPICAL INDEX

	PAGE
Opinion below .....	1
Jurisdiction .....	2
Question presented .....	2
Statute and regulations involved.....	2
Statement .....	2
Statement of points to be urged.....	6
Summary of argument.....	6
Argument :	
The entire issue of \$3.00 cumulative preferred shares of stock concerned here constituted an "original issue" within the meaning of Section 1802(a) of the Internal Revenue Code	9
Conclusion .....	29
Appendix :	
Excerpts from United States Statutes.....	App. p. 1

## TABLE OF AUTHORITIES CITED

CASES	PAGE
American Gas & Electric Co. v. United States, 69 Fed. Supp. 614.....	9, 14, 22, 23, 24, 28
Brewster v. Gage, 280 U. S. 327.....	28
Cleveland Provision Co. v. Weiss, 4 F. 2d 408.....	10, 25
Cuba Railroad Co. v. United States, 60 Ct. Cls.....	10
Edwards v. Wabash Ry. Co., 264 Fed. 610.....	10, 25
Fullerton Co. v. Northern Pacific, 266 U. S. 435.....	28
Goodyear Tire & Rubber Co. v. United States, 60 Ct. Cls. 448....	10
Grant, W. T., Co. v. Duggan, 94 F. 2d 859.....	9
Grant-Lees Gear Co., In re, 1 F. 2d 393.....	10
Helvering v. Taylor, 293 U. S. 507.....	19
Ohio State Life Ins. Co. v. Busey, 56 Fed. Supp. 410.....	9
Peck v. Elliott, 79 Fed. 10.....	26
Raybestos-Manhattan Co. v. United States, 296 U. S. 60.....	26
Rio Grande Oil Co. v. Welch, 101 F. 2d 454.....	9, 15, 20, 21, 22, 23, 24, 26, 27
Southern Pacific Co. v. Berliner, 176 F. 2d 671.....	9, 10, 14, 15, 16, 17, 18
	19, 21, 23, 25, 27, 28, 29
United States v. Pure Oil Co., 135 F. 2d 578.....	23, 24, 25, 26, 27
West Virginia Pulp & Paper Co. v. Bowers, 293 Fed. 144; aff'd, 297 Fed. 225; cert. den., 265 U. S. 584.....	10

### MISCELLANEOUS

House Report No. 969, 80th Cong., 1st Sess., pp. 1-2.....	28
Senate Report No. 713, 80th Cong., 1st Sess., pp. 1-3.....	28
Treasury Regulations 71 (1941 Ed.), Sec. 113.25(f).....	9

### STATUTES

Act of August 8, 1947, Chap. 518, 61 Stat. 921.....	27
Internal Revenue Code:	
Sec. 1800 (26 U. S. C., 1946 Ed., Sec. 1800) .....	9, 23
Sec. 1802 (26 U. S. C., 1946 Ed., Sec. 1802).....	16

No. 12611

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

UNITED STATES OF AMERICA,

*Appellant,*

*vs.*

CALIFORNIA ELECTRIC POWER COMPANY, a corporation,

*Appellee.*

---

## BRIEF FOR THE UNITED STATES.

---

### Opinion Below.

The opinion of the District Court [R. 64-71] is reported at 89 F. Supp. 269.

### Jurisdiction.

This appeal involves a claim for refund of documentary stamp tax in the amount of \$4,549.51 with interest. [R. 64-65.] The tax was paid under protest on or about January 28, 1942. [R. 72, 74.] Claim for refund was timely filed on or about January 24, 1946, and was rejected by the Commissioner of Internal Revenue on June 16, 1947. [R. 75.] Suit for refund was filed in the Dis-

trict Court on or about December 31, 1947 [R. 8], conformably with Section 3772 of the Internal Revenue Code. The District Court had jurisdiction of the case under Section 24, Twentieth, of the Judicial Code, now 28 U. S. C., Section 1346. Judgment of refund by the District Court was entered April 17, 1950. [R. 77-78.] Notice of appeal was filed June 14, 1950 [R. 79], pursuant to 28 U. S. C., Section 1291, upon which is based the jurisdiction of this Court.

### Question Presented.

Whether the District Court erred in failing to hold that in the circumstances the taxpayer corporation incurred original issue tax under Section 1802(a) of the Internal Revenue Code upon the entire issue of \$3 cumulative preferred shares of stock which it made in 1941.

### Statute and Regulations Involved.

These will be found in the Appendix, *infra*.

### Statement.

The facts, which were stipulated [R. 28-63], were found specially by the District Court as follows [R. 71-75]:

The California Electric Power Company (formerly named the Nevada-California Electric Corporation) is a corporation duly organized and existing under and by virtue of the laws of the State of Delaware, duly licensed to engage in business in the State of California. California



Electric Power Company's principal office is located at 3771 Eighth Street, City of Riverside, County of Riverside, State of California, and in the Southern Judicial District of California, Central Division. [R. 71-72.]

The documentary stamp taxes here involved, in the amount of \$4,549.51, were paid on or about January 28, 1942, by the California Electric Power Company to Ralph Nicholas, the duly appointed, qualified and acting Collector of Internal Revenue for the collection district comprising the State of Colorado. [R. 72.]

Prior to recapitalization on June 30, 1941, the taxpayer's capital stock consisted of 105,023 preferred shares having a par value of \$100 per share, and 84,683 common shares having a par value of \$10 per share. The stamp tax on this stock had been paid. [R. 72.]

On June 20, 1941, taxpayer's certificate of incorporation was amended to provide that each of the outstanding shares of old preferred stock were to be automatically converted into four-fifths of a share of \$3 cumulative preferred stock of a par value of \$50 each, and six shares of common stock of a par value of \$10 each. This amendment was to be and became effective June 30, 1941. This change did not affect the proportionate interests of the shareholders in the corporation's assets. [R. 72.]

The Commissioner of Internal Revenue has conceded that no stamp tax is due by virtue of the issuance of the new common stock. [R. 73.]

On June 30, 1941, unpaid cumulative preferred dividends on the old preferred stock of California Electric Power Company amounted to \$11 per share. [R. 73.]

In order to settle the arrearages of dividends the board of directors had previously, by resolution, on May 29, 1941, authorized the making of an offer to the preferred shareholders of one-fifth of a share of \$3 cumulative preferred stock and \$1 cash in full settlement of all arrearages on each share. The offer was to remain open until June 25, 1941, and was contingent on the amendment of the certificate of incorporation by the shareholders. [R. 73.]

Pursuant to the plan for settlement of the dividend arrearages taxpayer issued new \$3 stock on a one new for five old basis to the shareholders accepting the offer. Upon completion of the exchange, new capital sufficient to pay the dividend arrearages was transferred from surplus to the preferred stock account, so that the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividends into additional shares of stock representing capitalized surplus. [R. 73-74.]

The number of shares of new preferred stock at \$50 per share issued up to January 24, 1942, was 103,398. [R. 74.]

The taxpayer concedes liability and has paid the stamp tax due upon the shares issued in settlement of dividend arrearages. [R. 74.]

The Commissioner determined that the transfer of the surplus to the preferred stock account resulted in the dedication of additional capital; that this represented capital upon which no previous issue tax had ever been paid; and that the old capital and the new capital were so intermingled that it is impossible to determine which specific shares are represented by new capital added to the preferred stock account. [R. 74.]

The taxpayer, pursuant to the above ruling of the Commissioner, paid the sum of \$4,549.51 here in question under protest. This sum represents the difference between the amount conceded to be due by taxpayer on stock issued in settlement of dividend arrearages and that asserted by the Commissioner upon the entire issue of new preferred stock up to January 24, 1942. [R. 74.]

On or about January 24, 1946, California Electric Power Company filed with the Collector of Internal Revenue at Denver, Colorado, a claim for refund of stamp taxes paid in the amount of \$4,549.51, together with interest thereon as provided by law. [R. 75.]

The Commissioner of Internal Revenue, by letter dated June 16, 1947, rejected the claim for refund filed on or about January 24, 1946, as stated above. [R. 75.]

The District Court concluded as a matter of law [R. 75-76] to the net effect that the taxpayer's issuance of new preferred stock in exchange for old preferred stock did not constitute an "original issue" of stock within the meaning

of Code Section 1802(a) as it existed prior to January 24, 1942, and that accordingly no tax was due upon such issuance.

### Statement of Points to Be Urged.

The statement of points relied on by the United States appears in the record at pages 83-84. It may be summarized thus: That the court below erred (1) in concluding that in the conversion of taxpayer's outstanding preferred stock to new preferred, the issuance of the latter in partial satisfaction of dividend arrearage was sufficiently separate and distinct from the exchange of the new preferred for the old preferred as to allow an allocation to be made between the new and the old capital; and (2) in failing to conclude that the new capital, consisting of dividend arrearages, was added to and commingled with the old capital of the preferred capital stock account so that the added capital could not be identified with specific shares of the new preferred, and therefore an original issue tax was incurred as to all of the new issue of preferred.

### Summary of Argument.

The federal revenue laws impose a documentary stamp tax on each original issue of shares or certificates of stock by any corporation, whether on organization or reorganization. The question at bar is whether in the circumstances presented a certain issue of cumulative preferred stock was subject to the tax in its entirety as being an "original issue" within the meaning of the statute, the



Regulations, and the pertinent decisional authorities, or whether, as the taxpayer contends and as the court below held, the tax was imposable on only a part of the shares.

We think it plain that the tax lay on or with respect to all of the shares. This is so because the law is clear that if the permanent capital of a corporation is increased upon an issuance of stock, the stock constitutes an "original issue." An increase in capital means an increase in capital in the narrow sense in which the word "capital" is distinguished from "surplus." The tax is not on the amount of the capital increase; it is on the certificates of stock measured by their value. Accordingly, an entire new issue is taxable unless definite shares can be identified as having been issued against a given increase in capital. And as will be developed, *infra*, the taxpayer here did not bear its burden of proving in its action for refund that any particular shares could be segregated and earmarked against any certain part of the augmented capital which resulted from the recapitalization transaction concerned in this case.

In 1941, the taxpayer by amendment to its incorporation certificate called in its old preferred stock and exchanged it for a certain amount of new preferred and common stock. Had this been the whole of the transaction, there would have been no tax payable, because no increase of capital would have been thereby effected. However, that was *not* the whole of the transaction. Simultaneously with the charter amendment, the taxpayer's directors by appropriate resolution made an offer to the shareholders of

the old preferred to transmute their then unpaid dividend arrearages into shares of the new issue; and on completion of the exchange an amount sufficient to pay the dividend arrearages on the old stock of those accepting the offer was transferred from taxpayer's surplus account into the new preferred capital stock account. Thus the old preferred capital account was increased; and against the whole of that account there were now charged both the new shares which had been exchanged for the old and the new shares which took the place of the dividend arrearages—this without any allocation or segregation whatever. Since no definite shares of the new stock could or can be identified as having been issued against the capital increase, the entire issue is subject to the stamp tax.

Two decisions by this Court—and one of them a very recent case—lend adequate support to our position as will be demonstrated. The trial court paid little heed to those cases, however, but chose rather to rely almost entirely upon a Seventh Circuit decision. We think that that decision can be distinguished; but if it cannot be, then we assert that the Court of Appeals was there wrong in its interpretation and application of the governing principles of law. Nor is there any merit to the trial court's additional reliance upon the fact that Congress has now amended the law so as to limit application of the tax to the pro rata share of newly dedicated capital. As the trial court recognized, the amendment did not purport to have retrospective effect, and the legislative history clearly shows that it was intended to "change" the existing law. And certainly it is not the function of the courts to provide relief for taxpayers before the date that the legislature has seen fit.

## ARGUMENT.

**The Entire Issue of \$3 Cumulative Preferred Shares of Stock Concerned Here Constituted an "Original Issue" Within the Meaning of Section 1802(a) of the Internal Revenue Code.**

Under Sections 1800 and 1802(a) of the Internal Revenue Code (Appendix, *infra*), documentary stamp tax is imposed "On each original issue, whether on organization or reorganization, of shares or certificates of stock, \* \* \* by any corporation \* \* \*." If the capital of a corporation is increased upon an issuance of stock, the stock constitutes an "original issue" and this is true even though the new stock may merely be exchanged for previously issued stock. (*Southern Pac. Co. v. Berliner*, 176 F. 2d 671 (C. A. 9th); *Rio Grande Oil Co. v. Welch*, 101 F. 2d 454 (C. A. 9th); *W. T. Grant Co. v. Duggan*, 94 F. 2d 859 (C. A. 2d); *American Gas & Electric Co. v. United States*, 69 Fed. Supp. 614 (S. D. N. Y.); *Ohio State Life Ins. Co. v. Busey*, 56 Fed. Supp. 410 (S. D. Ohio). Cf. Treasury Regulations 71, Section 113.25 (f).) (Appendix, *infra*.)

An increase in capital means an increase in capital in the narrow sense in which the word "capital" is distinguished from "surplus." Cases cited, *supra*. The tax is on the certificates of stock measured by the value of the certificates; it is not on the amount of the increase in capital. (*American Gas & Electric Co. v. United States*, *supra*.) Wherefore, an entire new issue is taxable unless definite shares can be identified as having been issued against the increase in capital. (*Southern Pac. Co. v. Berliner*, *supra*; *Rio Grande Oil Co. v. Welch*, *supra*; *W. T. Grant Co. v. Duggan*, *supra*; *American Gas & Electric*



*Co. v. United States, supra.*) And the term "increase in capital" does not mean that new moneys must actually be paid in or new or additional property transferred to the corporation; it suffices if, for example, the corporation shifts part of its surplus into its fixed capital account thereby providing a capital increase. (*Southern Pac. Co. v. Berliner, supra.*)

On the other hand, the issuance of new certificates of stock in exchange for previously issued shares may result in only a reissue, nontaxable under Section 1802(a), if the issue is not accompanied by any increase in capital. (*Edwards v. Wabash Ry. Co.*, 264 Fed. 610 (C. A. 2d); *West Virginia Pulp & Paper Co. v. Bowers*, 293 Fed. 144 (S. D. N. Y.), affirmed *per curiam*, 297 Fed. 225 (C. A. 2d); certiorari denied, 265 U. S. 584; *Cuba Railroad Co. v. United States*, 60 C. Cls. 272.) And this is true even if after the exchange the shareholders have different classes of stock with different rights and privileges, so long as fixed capital does not mount as the result of the transaction. (*Cleveland Provision Co. v. Weiss*, 4 F. 2d 408 (N. D. Ohio); *Goodyear Tire & Rubber Co. v. United States*, 60 C. Cls. 448; *In re Grant-Lees Gear Co.*, 1 F. 2d 393 (N. D. Ohio); *Cuba Railroad Co. v. United States, supra.*) The determining factor which makes an issue "original" is not whether the certificates are new or different, or whether the shares of stock evidenced by the certificates are new or different, but whether the capital of the corporation, upon which new certificates are issued, is new or different.



In the case now before us, the taxpayer corporation had issued and outstanding immediately prior to June 30, 1941, 105,023 shares of preferred stock of the par value of \$100 each, and 84,683 shares of common stock of a par value of \$10 each upon which the stamp tax had been paid as an "original" issue. [R. 29, 72.] Effective as of June 30, 1941, taxpayer's certificate of incorporation was amended to provide that each of the outstanding shares of preferred stock, hereinafter called the "old" stock, should be automatically converted into four-fifths of a share of \$3 cumulative preferred stock of the par value of \$50 each and six shares of common stock of \$10 par. [R. 29, 72.] The District Court was correct in stating [R. 67] that the Government admitted below that this transaction, had it stood alone, would not have been subject to stamp tax—this because the capital of the corporation would not have been increased on the deal, nor would the proportionate interests of the shareholders in the corporation assets have been affected. [See R. 29, 72, and authorities cited, *supra*.]

However, such was not the whole of this recapitalization story. On the effective date of the amendment, the unpaid cumulative dividends on the old stock amounted to \$11 per share [R. 29-30, 73]; and in order to settle these dividend arrearages the taxpayer's board of directors had by resolution of May 29, 1941, authorized the making of an offer to the old shareholders of one-fifth share of \$3 cumulative preferred stock and \$1 cash in full settlement of all arrearages on each share. [R. 30, 73.] The

resolution recited [R. 62] that the new shares were to be issued pursuant to the offer "if, as, and when the dividend arrearages were waived, and in exchange therefor"; and taxpayer issued the new preferred at the rate of one share for each five shares of the old preferred to shareholders accepting. [R. 73.] Upon completion of this exchange, an amount sufficient to pay the dividend arrearage on the stock of those accepting the offer was transferred from taxpayer's surplus account into the new preferred stock account, so that, according to the parties' stipulation [R. 30] "the interest of the preferred stockholders accepting the offer was transmuted from a claim for dividend into additional shares of stock representing capitalized surplus."

For the necessary thorough understanding of the effect on taxpayer's capital structure of the 1941 transaction we are presently considering, it may be helpful to examine the table contained in paragraph (9) of the stipulation of facts [R. 30-31], and to explore its meaning. Remembering that pursuant to the amendment of the incorporation certificate each of the outstanding shares of old preferred was converted into four-fifths of a share of new preferred of the value of \$50 per share and six shares of common at \$10 par, it will be apparent that what happened here was that for each \$100 share of old preferred the taxpayer issued four-fifths of a share of new preferred, thereby reducing the preferred by \$60 a share and added the \$60 to the original common stock by issuing six new common shares therefor. Then and coextensively, as to the new preferred, the taxpayer increased the thus reduced preferred stock account by adding thereto the accumulation of \$1,047,230 in dividends, against which it issued one-fifth

of a share of new preferred, amounting to a par value of \$10 and which completed the \$50 value of each new share of preferred.<sup>1</sup>

While there was an increase in the value of the common stock as shown by the capital structure in paragraph (9) of the stipulation [R. 30-31], no new capital was added to the common stock account; no tax was incurred accordingly respecting that stock. The new capital, consisting of dividend arrearage of \$1,047,230, went into the new preferred stock account [R. 30], which was a dedication of capital from capital surplus to that capital stock account. As shown by the footnote immediately preceding, this new capital was commingled with the old capital in the preferred stock account. It could not and cannot be identified with specific shares. Therefore, an original issue tax was incurred as to 103,398 shares of new preferred stock ( $\$50 \times 103,398$  shares or \$5,169,900 at 11 cents for each \$100, which is concededly the correct tax rate, equals \$5,686.89). In other words, the whole issue of the new preferred was subject to tax under Code Section 1802(a) in accordance with the general tenets of law with which we began this discussion, and specifically,

---

<sup>1</sup>The reduction of the \$10,502,300 value of the old preferred by \$60 a share left a value therein of \$40 a share, or the reduced value of \$4,200,920 ( $105,023 \text{ shares} \times \$40 = \$4,200,920$ ). By adding to that result the accumulated dividends of \$1,047,230 ( $\$4,200,920$  plus \$1,047,230 = \$5,248,150) brings about the result shown in the table of 104,963 shares of new preferred at \$50 a share, amounting to the figure of \$5,248,150.

The \$60 value taken out of each share of the old preferred and added as six shares of common stock at \$10 a share increased the common stock account by \$6,301,380 ( $105,023 \text{ shares} \times \$60 = \$6,301,380$  plus \$846,830 = \$7,148,210), which accounts for the 714,821 shares of common stock at \$10 per share, or \$7,148,210, as shown in the table.



pursuant to the principle that an entire new issue is taxable under the statute unless definite certificates can be identified as having been issued against the increase in capital. (*Southern Pac. Co. v. Berliner*, 176 F. 2d 671 (C. A. 9th); *American Gas & Electric Co. v. United States*, 69 Fed. Supp. 614 (S. D. N. Y.).) And parenthetically, on that basis, *except as included in the tax of which the amount of the recovery sought here is apart*, no original issue tax has ever been paid in respect to the arrearage in dividends amounting to \$1,047,230. The taxpayer's concession as to liability "on the amount of new capital added to its capital account in cancellation of dividend arrearages and against which new Preferred Stock was issued," which concession is made in paragraph (12) of the parties' stipulation [R. 32], must be interpreted accordingly. So also must be read the trial court's fact finding No. X on the subject. [R. 74.]

The difference between the taxpayer's position and that of the Government is perhaps best brought into focus by the method by which the amount of refund was calculated here, in accordance with the taxpayer's claim. [R. 16, 77-78.] Paragraph V of the claim [R. 16] recites that—

The number of shares of new Preferred Stock at \$50 per share issued to January 24, 1942, was 103,398, on which  $4/5$  or \$40 per share, was tax-free, inasmuch as it represented a mere exchange for old Preferred Stock. There was involved, therefore, \$40 x 103,398 of old capital, or \$4,135,920, on which tax at \$.11 per \$100, or \$4,549.10, was overpaid on, to-wit, January 28, 1942.



Echoing this theory, the District Court concluded as matter of law [R. 75] that—

The issuance of new preferred stock in partial satisfaction of dividend arrearages was a sufficiently separate and distinct transaction from the exchange of new preferred stock for old as to allow an allocation to be made between the new capital thereby added and the old capital for which the exchange was made.

And precedently the trial court had determined [R. 75] that the taxpayer's failure to issue specific shares in lieu of certain specified shares or the failure to charge specific shares against any particular segment of capital or surplus—

does not necessarily make the entire issue of stock an original issue. Book entries alone are not decisive.

We submit that the only part of the trial court's conclusions which is in keeping with the law as this Court has stated it to be is the sentence last above quoted to the effect that book entries alone are not decisive. And with that statement the Government does not anyway disagree; it is everywhere accepted as a general principle of tax law. (E. g., *Southern Pac. Co. v. Berliner*, 176 F. 2d 671 (C. A. 9th).) However, while acknowledging that our view on the matter is not in accord with that of the District Court here [R. 69-70], we think that the just cited *Southern Pac. Co.* decision by this Court provides adequate refutation of the other and major aforementioned conclusions reached by the court below in this case, as does likewise this Court's prior decision in *Rio Grande Oil Co. v. Welch*, 101 F. 2d 454. Accordingly, we turn attention now to those two cases.

In *Southern Pac. Co. v. Berliner* the taxpayer railroad in 1940 substituted shares without par value for issued shares having \$100 par value on a share-for-share basis. Prior to the exchange the taxpayer maintained two capital stock accounts, one representing the par value of the issued and outstanding shares and the other representing amounts paid as premiums on shares issued, corresponding to a paid-in surplus to this extent. Following the exchange these accounts were combined. The Commissioner rejected a stamp tax refund claim on the ground that there had been an increase of capital which could not be allocated to any specific shares, hence the entire issue became taxable. That is of course the same ground on which refund in the instant case was denied by the Commissioner. The Commissioner's action was upheld in *Southern Pac. Co. v. Berliner* both by the District Court and by this Court, the trial court there saying in the course of its opinion (78 Fed. Supp. 696, 697-698 (N. D. Cal.)):

The courts have interpreted the term "original issue" as used in Section 1802, *supra*, to be applicable to a new issue where the capital stock account has been increased either by receipt of additional consideration for the new stock or by the transfer of a given amount from paid-in surplus or earned surplus. If definite shares of the new issue can be identified as having been issued against the increase in capital, the tax is levied only on such shares. If there is such an intermingling of old and new capital that such identification is impossible, the entire new issue is taxable. This is true because the tax is not on the capital behind the shares of stock but is measured by the par value of the shares (or actual value if not par value shares) represented by each stock certificate. \* \* \*

When the corporation had only par value stock its capital stock account represented the sum total of \$100 par value for each share of stock issued. The premium on capital stock represented paid-in surplus and, under Kentucky corporation law [which was the law of the taxpayer's domicile], could have been distributed as dividends, a disposition that could not have been made of any part of the capital stock account. With the exchange of the par value stock for an equal number of no-par value shares and the transfer of the amount in the premium account to the capital stock account, the total amount of capital behind the shares was increased. \* \* \* *While the \$6,304,845 remained in the premium account no shares of stock were issued against it and therefore, no original issue tax was ever paid with respect to that amount. When it became part of the capital stock account against which the new shares were issued without any allocation of specific shares to such transferred sum, each share represented both old and new capital and was thus taxable as an original issue under the statute.* \* \* \* (Italics supplied.)

The opinion of this Court, affirming the District Court's decision in *Southern Pac. Co.*, is an adoption of the views expressed by the lower court in that case plus only a discussion of the reasons for rejecting the taxpayer's specific argument there that under the controlling accounting classification of the Interstate Commerce Commission, the premium on capital stock involved was *always* a part of fixed capital, all surplus being gathered into other accounts; really, the taxpayer's sole thesis in the Court of Appeals was that capital had not in fact been augmented by reason of the exchange transaction concerned in *Southern Pac. Co.* because the corporate directorate did not so



intend. It was in respect to this plea regarding intention that this Court said (p. 674):

\* \* \* we agree that the record affords no clear picture of what the directors thought they were accomplishing by the disposition made of the premium account; and this state of confusion gives rise to the only substantial difficulty in the case. As this court observed in the cognate case of *Rio Grande Oil Company v. Welch*, 9 Cir., 101 F. 2d 454, 456, an increase or decrease in the stated capital of a corporation effects a fundamental change in the corporate structure; and book entries alone are not decisive of the matter. But we are satisfied that the corporate action taken in this instance, considered in the light of the Commission's grant of authority for the charter amendment, compels the conclusion that a dedication of additional capital in fact occurred.

These extended quotations from the trial court's opinion and that of this Court in *Southern Pac. Co.* amply demonstrate, we believe, the authoritative character of that case here. If there is *arguendo* a factual distinction between that case and this one, as the trial court here rather categorically stated [R. 69-70], we certainly fail to see that the distinction is one of any such difference as to warrant application of any different principle or set of principles than was applied by both the original and the reviewing forum in the railroad case. Indeed, it would seem to us that there is perhaps even greater warrant here for the application of those rules; so far as we are aware, the taxpayer in the instant case has never contended that the 1941 exchange was not intended to augment capital. And we think we have clearly demonstrated by exploration of the table contained in the parties' stipulation [R. 31] that no such con-



tention could in the circumstances be made in this case. Book entries are *not* decisive, but while in *Southern Pac. Co.* they tended to show with the aid of extrinsic evidence, or at least the taxpayer so claimed, that no addition to capital was effected by the exchange, here they tend to show that there was. Thus there is really *more* evidence in this case favoring imposition of the tax than there was in the other. And if there were *not*, certainly we have as the result of this exchange nothing more than a record which, to use the language of this Court's *Southern Pac. Co.* opinion, quoted *supra*, "affords no clear picture of what the directors thought they were accomplishing" by the critical accounting changes of 1941. The sole test of whether stock is an "original issue," as firmly expressed by this Court in its *Southern Pac. Co.* opinion, is whether a dedication of additional capital occurred *in fact* as a result of the given transaction.

And be it remembered too, of course, that this is a refund action where the burden of proof belongs onerously to the taxpayer. (*Helvering v. Taylor*, 293 U. S. 507.) It lies with the taxpayer to prove here, if it would escape tax on the entire new preferred stock issue of 1941, that definite shares could and can be identified with certainty as having been issued against the increase in capital; and surely that burden of proof is not discharged by resort to theoretical possibilities of identification such as the trial court used here. [R. 66-67.] We reiterate: Shares or certificates of stock are said to be of "original issue" when they are issued against capital which for the first time is included in the capital stock account. In the transaction now being considered, the amount of \$1,047,230 which was transferred from surplus represented capital never previously included in the capital preferred stock account;

and the old and new capital were so intermingled that it was and is impossible to tell which specific shares are represented by the new capital added to the preferred stock account. Each new preferred stockholder, *regardless of whether he was one of those who had waived his right to the dividend arrearages*, received an interest in the newly augmented capital measured by the number of shares held. Each new preferred share issued thus constituted a new and a different certificate of interest in the newly adjusted preferred capital of the corporation and, consequently, was a kind never before issued.

The trial court gave no explanation whatever for its bald statement [R. 69-70] that this Court's decision in *Rio Grande Oil Co. v. Welch*, 101 F. 2d 454, is "clearly distinguished from the present case on the facts." And, again, we think that there *is* no distinction which would warrant the difference in conclusion reached here; indeed, for reasons hereinafter explained, we should even suppose this to be an *a fortiori* case from *Rio Grande Oil Co.* There, as here [R. 2], the taxpayer was a Delaware corporation doing business in California. Pursuant to an amendment of its incorporation certificate, Rio Grande Oil issued five shares of new non-par value stock to its stockholders in exchange for each share of outstanding \$25 par value stock. Concurrent with the exchange, the corporation made a reappraisal of its property upward, resulting in the transfer of approximately \$30,000,000 from surplus to the capital stock account. Affirming the decision of the trial court, this Court held that the exchange was taxable in full as an "original issue." In that case as in this, the primary source of authority for the exchange of stock lay in an amendment to the certificate

of incorporation. Unlike this case, however, the amendment in *Rio Grande Oil* specifically declared that the exchange was to be effected without any transfer of surplus or undivided profits to capital account to represent the new issue. In that case as in this one also, it was a corporate resolution, which was an integral part of the exchange transaction, that gave rise to the tax question, the pivotal resolution in *Rio Grande Oil* stating that the corporate officers were authorized to set up as the valuation of the new non-par shares the proper reappraised value of the corporation's property and to assign to such valuation any portion of the surplus arising through the revaluation of the property. That, as has been noted, was done; and book entries were made crediting the corporation's liability account with (p. 456) "Value of capital stock outstanding appreciation \$30,000,000." The transfer from surplus was also shown on the taxpayer's application to list its new stock on the New York Exchange. Despite the words of the charter amendment explicitly negating an increase in capital, Judge Healy said for this Court<sup>2</sup> in respect of the *Rio Grande Oil* exchange transaction (p. 456):

The intricacies of the book entries need not be explored further. They are inexplicable except on the theory of a transfer of surplus from appreciation, together with paid in surplus, to capital account. Book entries alone, however, would not be decisive of the matter. An increase or decrease in the stated capital of a corporation effects a fundamental change in the corporate structure \* \* \*.

---

<sup>2</sup>Judge Healy is also the author of this Court's *Southern Pac. Co.*, *supra*, opinion.



And Delaware law, the Court said (p. 457), permitted the capital of a corporation to be increased by resolution of the directorate setting over surplus to capital account. The Court struck down taxwise the restrictive words of the charter amendment thus (p. 457):

The amendment \* \* \* in no wise determined what was to be done thereafter in the way of adjustments. While the stockholders no longer had par value stock, they still had certificates to exchange; and the incidence of the stamp tax is at the time of the exchange.

\* \* \* \* \*

The exchange of shares was thus accompanied by an increase in capital through a transfer of surplus to capital account, and the transaction was taxable.

There is nothing in the amendment of the corporate certificate to be struck down here; in fact there is nothing whatever in this case to belie the transfer of surplus to capital and the inextricable commingling of the old capital and the new capital as augmented by the transfer. As in *Rio Grande Oil* (p. 457), so all the more here—

We cannot but assume that the officers knew what they were about [in making the shift of accounts] and that they correctly interpreted the board's action.

Probably the case most nearly in point here, factually, is *American Gas & Electric Co. v. United States*, 69 Fed. Supp. 614 (S. D. N. Y.). There certificates for some 300,000 shares of preferred stock were exchanged for the same number, kind, and denomination of new shares of preferred plus \$5 per share and a further small amount representing adjustment of dividends. The refund claim in *American Gas* was predicated mainly upon the theory



that the only tax payable on the exchange was that which was calculable from the actual amount of the capital increase brought about in the transaction by way of transfer from surplus. As here, the Commissioner asserted that the entire new issue was subject to tax. The court held with the Commissioner, saying in significant part (p. 618):

This tax [under Code Sections 1800 and 1802 (a)] is a tax on the document, the certificate of stock, and not on the transaction. \* \* \* The tax is not a tax on the capital, *i. e.*, the assets received by the corporation upon the original issuance of the certificates. Nor is it a tax upon the amount, if any, transferred from surplus to capital. It is a tax upon the document and not upon the property which it describes.

However, the Government's urging of the *American Gas* case as authoritative here received almost as scant notice below [R. 69] as did this Court's decisions in *Rio Grande Oil* and *Southern Pac. Co.* The trial court in the matter at bar relied almost entirely upon a Seventh Circuit decision, *United States v. Pure Oil Co.*, 135 F. 2d 578, which it declared [R. 68, 70] to have been decided "on substantially the same facts as we have in the instant case." We do not agree that the facts of *Pure Oil*, correctly interpreted, are substantially the same as those presented here. They differ in the same material respect as the facts of *American Gas* differed from those of *Pure Oil*. The distinction is perhaps best perceived by reference again to the *American Gas* opinion, where in discussing the *Pure Oil* case the court said (p. 620):

Plaintiff contends that the transaction here was clearly analogous to the transaction in the *Pure Oil* case. *It says that the only distinction between the two*

*cases is that here plaintiff, instead of using the amount transferred from surplus to capital as the basis for issuing additional shares as a dividend [as was done in Pure Oil], used it as the basis for increasing the capital liability per share from \$94 to \$100; that, in other words, instead of issuing one new share representing the same capital liability of \$94 as the old share, and a separate share representing a capital liability of \$6—as it might have done—it issued a single share representing a capital liability of \$94 plus \$6.*

*But this distinction is important. \* \* \** (Italics supplied.)

And the court continued in *American Gas* (p. 620):

The fallacy in plaintiff's position is that it takes an average and assumes that each old share exchanged represented a capital liability of \$93.9995 per share. If that were so, the amount transferred from surplus to capital might be treated as a distribution or a dividend, upon each share and an allocation made between the shares issued in payment of such distribution or dividend and the shares issued in exchange for the old stock, as was done in the *Pure Oil* case. But that is impossible here, for the shares as to which such a distribution or dividend might properly be said to have been made cannot be identified and segregated from the others. \* \* \*

In other words, the court in *American Gas* read the *Pure Oil* decision as concerning in reality an exchange of old stock for new without any addition to capital, and a *separate* issuance of the new stock as a charge against the newly transferred capital in payment of the dividends involved there. If that interpretation was correct, *i. e.*, if in *Pure Oil* there were *two distinct* transactions, then per-

haps the result reached in the *Pure Oil* case was correct, for in such circumstances definite shares could be identified as having been issued against the increase in capital. On that basis the instant case is certainly to be distinguished from *Pure Oil*, where the Court of Appeals said (p. 579) that the undisputed "fact" was that the old preferred stock was exchanged share for share and the dividend arrears were satisfied by issuance of additional shares—albeit at one and the same time. But we do not believe that the transaction in *Pure Oil* can be so interpreted. The "two" transactions there were actually but parts of a whole. In short, we believe that that decision was wrong; and to our minds, it conflicts with the basic rationale of this Court in both *Southern Pac. Co.* and *Rio Grande Oil* as hereinbefore discussed. In the *Pure Oil* case, the Court of Appeals said (p. 579):

The additional shares issued in satisfaction of unpaid dividends represented the only contribution to capital effectuated; that and that alone was an original issue \* \* \*.

Admittedly, the additional shares issued equaled the capital contributed in satisfaction of dividends both in *Pure Oil* and here. But *Edwards v. Wabash Ry. Co.*, 264 Fed. 610 (C. A. 2d), cited *inter alia* by the court in *Pure Oil* to support the just quoted statement, is itself authority that the tax is not laid on capital or on each stock certificate that is issued, but on each "original issue" of certificates. The entire issue both in *Pure Oil* and in this case was the issue first in point of time whereby the corporation put out stock certificates evidencing ownership by its shareholders of its capital as increased. And that is all that is necessary for imposition of the tax. (*Cleveland Provision Co. v. Weiss*, 4 F. 2d 408 (N. D. Ohio).) It might per-



haps rightly be said that the stamp tax is the only tax in the books where the form of a transaction controls over its substance; the literal language of the statute is not to be departed from for whatever cause. (*Raybestos-Manhattan Co. v. United States*, 296 U. S. 60.)

The court in *Pure Oil* attempted to distinguish this Court's *Rio Grande Oil* decision by saying (p. 580) that the basis for the latter was absent in the former in that in *Rio Grande Oil* the court "found" that the transaction effectuated a complete reorganization and a fundamental change in the entire capital structure, whereas the situation in *Pure Oil* was that the corporate structure remained the same except as to the additional shares issued in satisfaction of the unpaid dividends. But of course this Court did not "find" in *Rio Grande* that the transaction there effected a complete reorganization of the capital structure. It determined as a matter of law that an increase in the stated capital effects a fundamental change in the corporate structure. And of course that is the law. (See also *Peck v. Elliott*, 79 Fed. 10 (C. A. 6th).) The stamp tax attaches to any fresh stock issue which is attendant upon such change or is a part of it, and upon the whole issue, unless definite shares of the new issue can be positively identified as having been issued against the increase in capital. Where old and new capital are so mingled in the course of the transaction that segregation is not possible there is no escaping the tax. We repeat that the stamp tax is a documentary tax pure and simple. It is not levied on the capital behind the shares; it is *measured* by the par value of the shares or by the actual value of non-par shares represented by each stock certificate which is made a charge against the capital account. Such, we



think, is the clear meaning of this Court's pronouncements in *Southern Pac. Co.* and in *Rio Grande Oil*, and the application of those precepts to the facts at bar should result in reversal here. Particularly should that be so when we recall that unlike *Rio Grande Oil* and unlike *Southern Pac. Co.*, the book entries here do tend affirmatively to demonstrate as we have shown (fn. 1, *supra*) that the newly augmented capital was an indivisible entity with the entire issue of the new preferred a charge against it. And there were certainly not "two transactions" here [cf. R. 70], but only one. (See *Rio Grande Oil Co. v. Welch, supra.*)

We have stated that the District Court's chief reliance here was in the *Pure Oil* case, and we have shown that that reliance was a mistaken one. However, the trial court resolved all possible doubt against the Government by reference to the 1947 amendment to the law. This was again a mistake. Code Section 1802(a) was amended by the Act of August 8, 1947, c. 518, 61 Stat. 921, approved August 8, 1947, the text of the amendment being set forth in the margin.<sup>3</sup> The effect of the new law is to limit application of the tax to the pro rata share of newly ~~deducted~~ *deducted* capital. The trial court acknowledged [R. 70] that the

---

<sup>3</sup>Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 1802(a) of the Internal Revenue Code is amended by deleting the period at the end of the next to the last sentence and inserting in lieu thereof the following: "Provided further, That where such certificates (or shares, where no certificates are issued) are issued in a recapitalization, the tax payable shall be that proportion of the tax computed on such certificates or shares issued in the recapitalization that the amount dedicated as capital for the first time by the recapitalization, whether by a transfer of earned surplus or otherwise, bears to the total par value (or actual value if no par stock) of such certificates or shares issued in the recapitalization."

amendment is not retroactive. Certainly it is not retroactive in terms, and the legislative history shows that it was intended to effect a "change" in existing law. (See H. Rep. No. 969, 80th Cong., 1st Sess., pp. 1-2, and S. Rep. No. 713, 80th Cong., 1st Sess., pp. 1-3.) And it is well known of course that statutes apply only prospectively unless express statement or necessary implication requires retrospective application. (*Brewster v. Gage*, 280 U. S. 327; *Fullerton Co. v. Northern Pacific*, 266 U. S. 435.)

Although enactment of the amendment as a "change" in existing law is in itself an argument that we are correct in our statement of the old law and in its application to the facts presented here, the trial court said here [R. 70]:

\* \* \* [the amendment] clearly indicates that the interpretation of the former act did not meet the approval of Congress. Under such circumstances, I see no reason why I should meekly submit to the Commissioner's rulings thereby helping to perpetuate an inequity that Congress has already recognized and precluded its repetition in the future.

Apparent hardship to a taxpayer does not justify departure from the literal language of a revenue law. (*American Gas & Electric Co. v. United States*, *supra*.) Moreover, the trial court in speaking about "meekly" submitting to the Commissioner's rulings seems quite to have overlooked the fact that those same rulings were expressly approved by this Court in the *Southern Pac. Co.* case after enactment of the new amendment. And if we are speaking now of inequities, it would certainly seem to us most inequitable that the trial court should be affirmed here and the taxpayer permitted to escape the tax when the South-

ern Pacific Company was made to pay by application of the same statute and the same rulings to substantially the same kind of transaction. The disputed tax in this case amounts only to some \$4,500. The tax involved in the *Southern Pac. Co.* case was some \$46,000.

### Conclusion.

The decision of the District Court should be reversed.

Respectfully submitted,

THERON LAMAR CAUDLE,  
*Assistant Attorney General,*

ELLIS N. SLACK,

A. F. PRESCOTT,

MARYHELEN WIGLE,

*Special Assistants to the Attorney General,*

ERNEST A. TOLIN,  
*United States Attorney,*

E. H. MITCHELL,  
*Assistant United States Attorney.*

November, 1950.









## APPENDIX.

### Internal Revenue Code:

#### SEC. 1800. IMPOSITION OF TAX.

There shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in sections 1801 to 1807, inclusive, \* \* \* the several taxes specified in such sections. (26 U. S. C. 1946 ed., Sec. 1800.)

#### SEC. 1802. CAPITAL STOCK (AND SIMILAR INTERESTS).

(a) [as amended by Sec. 1 of the Revenue Act of 1939, c. 247, 53 Stat. 862, and Sec. 210 of the Revenue Act of 1940, c. 419, 54 Stat. 516]. *Original Issue*.—On each original issue, whether on organization or reorganization, of shares or certificates of stock, or of profits, or of interest in property or accumulations, by any corporation \* \* \* holding or dealing in any of the instruments mentioned or described in this subsection or section 1801 \* \* \*, on each \$100 of par or face value or fraction thereof of the certificates issued by such corporation \* \* \* (or of the shares where no certificates were issued), 11 cents until July 1, 1941, and 5 cents thereafter; *Provided*, That where such shares or certificates are issued without par or face value, the tax shall be 11 cents until July 1, 1941, and 5 cents thereafter, per





No. 12611

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

UNITED STATES OF AMERICA,

*Appellant,*

*vs.*

CALIFORNIA ELECTRIC POWER COMPANY, a corporation,

*Appellee.*

---

Upon Appeal From the District Court of the United States  
for the Southern District of California,

---

## BRIEF FOR APPELLEE.

---

DEMPSEY, THAYER, DEIBERT & KUMLER,

THOMAS R. DEMPSEY,

WELLMAN P. THAYER,

ARTHUR H. DEIBERT,

WILLIAM L. KUMLER,

1104 Pacific Mutual Building, Los Angeles 14,

*Counsel for Appellee.*

HENRY W. COIL,

*Associate Counsel.*

FILED

DEC - 4 1950

PAUL P. O'BRIEN,

CLERK



## TOPICAL INDEX.

	PAGE
Statement .....	1
Summary of argument.....	1
Argument .....	4
Conclusion .....	24

## TABLE OF AUTHORITIES CITED.

CASES	PAGE
American Gas & Electric Co. v. United States, 69 Fed. Supp. 614.....	11, 12, 13, 17, 18, 19, 20, 22
Rio Grande Oil Co. v. Welch, 101 Fed. 2d 454.....	8, 10, 11, 12, 16, 19
Southern Pacific Co. v. Berliner, 176 Fed. 2d 671.....	8, 10, 12, 13, 14, 16, 19, 22, 25
United States v. Pure Oil Co., 135 Fed. 2d 578.....	13, 14, 16, 17, 18, 19, 20, 21, 23
W. T. Grant Co. v. Duggan, 94 Fed. 2d 859.....	19

### MISCELLANEOUS

House Ways and Means Report No. 969 on H. R. 3613.....	22
--	----

### STATUTES

Internal Revenue Code, Sec. 1802.....	22
---------------------------------------	----



No. 12611  
IN THE  
**United States Court of Appeals**  
FOR THE NINTH CIRCUIT

---

UNITED STATES OF AMERICA,

*Appellant,*

*vs.*

CALIFORNIA ELECTRIC POWER COMPANY, a corporation,  
*Appellee.*

---

**BRIEF FOR APPELLEE.**

---

**Statement.**

The facts were stipulated and were specially found by the District Court, as stated by appellant in its brief.

**Summary of Argument.**

It is respectfully suggested that the appellant in its brief (pp. 6-7) in stating the question at bar to be “\* \* \* whether in the circumstances presented a certain issue of cumulative preferred stock was subject to the tax in its entirety as being an ‘original issue’ within the meaning of the statute, the Regulations, and the pertinent decisional authorities, or whether, as the taxpayer contends and as the court below held, the tax was imposable on only a part of the shares,” has assumed what the appellee contends and believes is the very point in dispute. In this statement, and time after time in its brief, appellant refers to the

transactions here in question as that "certain issue" of stock as though there were no question but that only one single transaction were involved. Actually, as viewed by the appellee and apparently by the trial court, the real question is whether the two transactions in question were sufficiently separable so as to allow an allocation between them to be made. Appellee therefore respectfully submits for the consideration of this Court that the question at bar can be more precisely and accurately stated as follows: Whether the issuance of new preferred stock in exchange for old preferred stock constitutes an "original issue" of stock where the old stockholders have the option, independent and separate from this exchange, of accepting or refusing additional shares of new preferred stock to be issued in partial settlement of dividend arrearages on the old preferred stock. Appellee believes that to pose the question in this form is to answer it, in its favor.

Regardless of how the problem is stated appellee submits that the transactions here involved were not only sufficiently separable to permit an allocation to be made between the old and the new capital but that such allocation was in fact made and was implicit in the two transactions from their inception. The conversion of each share of old preferred stock into  $\frac{4}{5}$  share of new preferred stock and 6 shares of common stock was automatic, mandatory and instantaneous on June 30, 1941. It covered a certain definite invariable amount of capital, viz., \$11,349,130, no more and no less. It was not a taxable transaction.

The other transaction was optional, voluntary and elective as to the several stockholders and involved progressive accretions to capital and issues of stock which were taxable as made from time to time in total amount by what-

ever was the excess above \$11,349,130. Indeed it requires some acumen and effort to combine or confuse these two transactions.

The appellant in effect concedes that if the transactions are separable, no tax will apply to the exchange of new for old preferred stock when it says (Brief p. 7): "Had this been the whole of the transaction, there would have been no tax payable, because no increase of capital would have been thereby effected."

Appellant then asserts that this was not the whole of the transaction (Brief p. 7) because "simultaneously" the directors made an offer to issue new stock in partial payment of dividend arrearages. It is respectfully submitted that this conclusion is erroneous both in fact and in law, because the two transactions were authorized by two different groups, at two different times, in separate meetings, and were consummated at different times.

Finally, the appellee will attempt to correct what apparently is a misunderstanding on the part of the appellant of appellee's argument with respect to the amendment of the law applicable to such transactions. Appellee does not now and has never claimed that the amendment in question has retroactive effect, nor does the appellee ask the Court to "provide relief for taxpayers before the date that the legislature has seen fit" (Brief p. 8). The appellee has merely pointed out that where the Congress has acted to prevent inequities in the future, the Court is certainly empowered to refuse to extend the application of the Commissioner's repudiated doctrine to cases not squarely within that doctrine.

## ARGUMENT.

The appellee has no fault to find with the statement of legal principles in appellant's brief in the first paragraph on page 9, assuming, of course, that there has been, in each case, only one exchange or other similar transaction. In the second paragraph on page 9 appellant states that an entire new issue is taxable "unless definite shares can be identified as having been issued against the increase in capital." If appellant means to imply that by "definite shares" is meant specific identification of each share by its number and the date and page of the journal entry under which that share is issued and capital added, then appellee believes that the cases cited do not stand for any such principle, as will be pointed out in later analysis of those cases. The Courts should not be burdened with such voluminous, detailed accounting records. If the statement means, however, that a "group" or "block" or "issue" of stock must be associated and identified with a capital addition then the appellee agrees therewith.

Appellee likewise agrees with the appellant's statement of facts on page 11 of its brief concerning the exchange of new for old preferred stock. The point at which the appellee and appellant part company is in the description of the issue of preferred stock in partial satisfaction of dividends, and the legal conclusions to be drawn therefrom.

Appellant treats the exchange of new for old preferred stock, and the issuance of stock in partial satisfaction of dividends, as one single, inseparable transaction. The facts simply do not support this treatment. The exchange of stock was authorized by an amendment to the appellee's Certificate of Incorporation adopted at a meeting of the stockholders on June 20, 1941 [R. 29 and 34]. This exchange took place *automatically* on June 30, 1941, inde-



pendent of any further action by any stockholder, of either an affirmative or negative nature [R. 29]. *"This was the sole and only change made in the capital structure by said amendment to the Certificate of Incorporation."* [Stipulation R. 29.] On an entirely different (and earlier) date, May 29, 1941, a different group (Board of Directors) had offered to issue additional shares of stock to any preferred stockholder who consented thereto in partial satisfaction of unpaid dividends due that stockholder [R. 62-63].

Some, but not all, of the stockholders accepted the offer of additional new stock in lieu of dividends, at various times during the ensuing six months. Upon acceptance of this offer new stock was issued, as stipulated [R. 30], *"if, as and when the dividend arrearages were waived, and in exchange therefor. \* \* \**" (Italics supplied.)

Obviously it was possible for a stockholder to take part in the "conversion" without taking part in the other transaction—the new issue of stock in exchange for dividends. That some stockholders actually did this is shown by the stipulation [R. 31, par. 9(b)].

The fundamental error of appellant's position is well illustrated in its brief (p. 12) where, after discussing the automatic conversion of old into new stock, it says "Then and coextensively, as to the new preferred, the taxpayer increased the thus reduced preferred stock account by adding thereto the accumulation of \$1,047,230 in dividends, against which it issued one-fifth of a share of new preferred, amounting to a par value of \$10 and which completed the \$50 value of each new share of preferred."

New capital was not added "then and coextensively" with the automatic conversion. There was no change in capital structure by reason of the stock conversion authorized by the amendment to the appellee's Certificate of Incorpora-

tion [R. 29]. New capital was added "if, as and when dividend arrearages were waived, and in exchange therefor. \* \* \*" [Stipulation R. 30].

Appellant insists that the addition of new capital caused a "commingling" of old and new capital. This is believed to be no more true than to say that any issue of additional stock which thereby increases capital causes commingling. To illustrate suppose that a corporation accomplished a share for share exchange of par value preferred stock, thereby causing no change in the capital stock account. Suppose further that the stockholders were given the option to purchase additional shares of preferred stock at par for cash. Shareholder X owns five shares of preferred stock, par value one dollar each. He exercises his option at or near the time of exchange and purchases five additional shares of preferred stock for cash at par, one dollar each. His cash is added to and "commingled" with the capital of the company. It is believed that any accountant would say that the only new thing entering the capital account would be the cash so received, and would have no difficulty in segregating the old capital from the additional capital against which new shares were issued. The value per share of his stock has not been changed either by the exchange or the issue of additional shares for new capital. Does it matter that in the present case claims were waived rather than cash paid for the additional stock?

Returning to the instant case, let us view these two transactions for a moment from the standpoint of the non-consenting shareholder.

Has such a stockholder's claim in dollars against the capital stock account been changed in any way by the automatic conversion of stock? Obviously not. Has the value of his stock been increased or changed in any manner

by the transfer of capital to the stock account (bearing in mind that for each dollar added to the stock account new stock in exactly that amount is issued on an if, as and when basis) to cover additional shares issued? Again, obviously not.

Perhaps the transactions as viewed by the appellee can be epitomized in the language of the trial court as follows [R. 66-67]:

Stated simply for the purposes of illustration, the two transactions may be compared as follows: If shareholder A had 50 shares of the original preferred stock, following the amendment he now has 40 shares of the new preferred stock. If he accepts the offer of stock for dividend arrearages he receives ten additional shares of the new preferred stock and \$50.00 in cash. At the same time there is a transfer from surplus to the capital stock account of an amount equal to the share value of the 10 additional shares.

If shareholder B had 50 shares of the original preferred stock, following the amendment he also now has 40 shares of the new preferred shares. If he does not accept the offer of the stock for the dividend arrearages he, of course, receives no additional shares and there is no transfer of any surplus to the preferred stock account. As to shareholder B, there has been no change except an exchange of old preferred shares for new preferred shares. His proportionate claim against the corporation's assets remains unchanged.

The essence of this illustration lies in the fact that the automatic conversion took place regardless of shareholder B's non-acceptance of the option to acquire additional stock. In other words, the first transaction (authorized by a different group, on a different date, and to be consum-



mated at a different time) could and did happen independently of the action of shareholders on the offer of additional stock, and without changing the dollar value of his claim on the company's assets.

The appellee therefore asserts that the two transactions were sufficiently separable that no new capital could be said to have been added by the automatic conversion of stock. New capital was added only if, as and when, and to the extent, that stockholders accepted new stock. Accordingly, only the stock issued against the new capital is subject to the original issue tax.

Let us now examine the cases upon which the appellant relies for its assertion that the trial court's conclusions regarding this case are not in keeping with the law applicable thereto (Brief p. 15).

Appellant understandably attempts to bring the present case within the law laid down by this Court in *Southern Pacific Co. v. Berliner*, 176 Fed. 2d 671, and *Rio Grande Oil Co. v. Welch*, 101 Fed. 2d 454. Neither of those cases is in point. Briefly, the reason is that the fundamental issue in each of those cases was whether *any* new capital was added as a result of an admittedly single transaction. Here there is no question that new capital was added, but the issue is whether stamp tax is due upon a conversion of old into new stock merely because additional shares representing new capital are issued in a *separate transaction*.

Since the appellant has chosen to rely so heavily on those two cases a more thorough examination of their respective facts is in order.

In *Southern Pacific*, the company exchanged stock having a par value of \$100, share for share for new no-par stock and simultaneously transferred into the capital ac-



count \$6,304,845. It is perfectly obvious that the equity or share value of *each share* is thereby increased from \$100 to \$100 plus its pro rata share of the new capital. In other words, the asset value of each share included both old and new capital. The intermingling of old and new capital was clear and the trial court properly so found. On appeal, the company abandoned this issue and relied entirely upon the proposition that the \$6,304,845 was not new capital because it was for practical purposes always a part of capital. This Court accurately and concisely stated that the issue “\* \* \* narrows down to the single question whether the Commissioner was right in finding that the exchange effected an increase in capital account” (p. 673), and decided only the issue as to whether this amount added by this single transaction was new or old capital, rightly concluding that it was new capital because it represented money previously available for dividends now capitalized.

Here the appellee does not deny that new capital was added by the issuance of new stock in partial satisfaction of dividend claims. Appellee does deny that any new capital was added as a result of the conversion of old into new stock. Clearly this is so because the equity value or proportionate claim against the company's assets is unchanged thereby. Indeed the parties have stipulated that (referring to the conversion) “This was the sole and only change made in the capital structure by said amendment to the Certificate of Incorporation.” [R. 29.] It is solely upon the conversion that appellee's claim for refund of stamp tax is based. The mere fact that by another and separate transaction new and additional stock was issued to some, but not all, of the stockholders in exchange for dividend arrearages, and in the amount of the arrearages settled thereby, does not serve to increase

the equity value or share value or add to the capital back of the previously converted shares. The new capital is added only if, as, and when new shares are issued for dividend arrearages. In *Southern Pacific* the equity value of each new share was increased by its share of the new capital because it was no-par stock. Here the new capital is represented by claims against it in the form of new shares having par value equal to the new capital. This is a vital distinction between the two cases.

*Southern Pacific* would be here in point only if in that case new shares of the same share value had been exchanged for old, and then additional shares had been issued against the new capital. This, of course, did not happen.

*Southern Pacific* is, therefore, not in point as was recognized by the trial court.

Again in *Rio Grande Oil Co.*, referred to by appellant as an *a fortiori* case, the primary issue was not whether intermingling had occurred but whether *any* new capital had been added by the transaction. The problem arose out of the transfer of appreciation surplus to the stock account in connection with an exchange of stock. The company had issued 5 shares of new *no-par* stock in exchange for one share of \$25.00 *par stock* and at the same time transferred a large sum to the stock account. If this transfer to stock account in fact amounted to addition of new capital then it is obvious that the 5 shares of new stock now represented, not \$25.00 as before, but a new equity value of \$25.00 plus the pro rata share of new capital. In other words, each share was a claim against both old and new capital. The Court therefore stated the issue to be "whether the exchange made by the appellant was effected without increase of its capital" and found that such an

increase had occurred because the value of each share was increased by the new capital. Only one exchange of stock was there involved, rather than two exchanges as here. In the instant case the conversion of old into new stock did not in itself increase the equity or book value of the stock, nor was the equity or book value of the exchanged shares affected in any manner by the issue in another and separate transaction of additional shares and the appropriation of new capital to those shares if, as, and when issued. The *Rio Grande* case would only be in point had the exchange of new stock for old stock in that case been effected (without changing its asset value or par value) and then additional shares issued if, as, and when the additional capital was dedicated.

It is believed that the differences in the legal issue presented, as well as the factual differences, are sufficient to justify what the appellant terms the "bald statement" of the trial judge (Brief p. 20) that *Rio Grande* is "clearly distinguished from the present case on the facts." (Brief p. 20.) In addition to being informed by briefs of counsel in the cause below, it is suggested that the trial judge in the present case was thoroughly familiar with the facts of *Rio Grande* inasmuch as that judge was, as United States Attorney, one of the counsel for the United States Government in the *Rio Grande* case.

We proceed now to examine what the appellant asserts is the case most nearly in point factually, *American Gas & Electric Co. v. U. S.*, 69 Fed. Supp. 614 (S. D. N. Y.).

That *American Gas & Electric Co.* is distinguishable from the present case is apparent from an examination of the facts there involved. There the company had outstanding a number of shares of *no-par* stock which had been issued at varying prices. The company issued the



same number of shares of new stock of par value \$100 and transferred to capital from surplus an amount equal to the difference between the par value of the new shares and the *average* book value or capital stock liability of the old shares. A further adjustment to the capital account was made by adding thereto from surplus an amount equal to the difference between par and *average* book value of some 39,162 of the new shares issued to the public through underwriters for cash, at par. The Court held the entire issue taxable as an original issue, since the new and old capital was mingled and no shares could be identified or segregated from the others. In that case each new share, when issued, immediately represented an interest in capital with a new and different value, while in the case at bar the exchange of new for old stock (both of par value) in and of itself effected no change in the capital account or the value of the stock itself. Furthermore, the other transaction by which stockholders could waive dividends and receive new stock did not change the value of the stock exchanged by so much as one dollar—new stock being issued and new capital being added dollar for dollar.

Actually *American Gas* and *Southern Pacific* are perfectly in harmony, representing merely two sides of the same coin. In *Southern Pacific* the exchange was of par for no par stock and the addition of new capital, so the share value of *each share* was par plus pro rata value of new capital. In *American Gas* the exchange was of no-par for par stock and the addition of sufficient new capital so that the share value of each new share was old value plus new capital which equalled the new share value of par. In both of the cited cases it is clear that each share's value is changed by the addition and intermingling of new capital and old. In the instant case the conversion of old



into new stock caused no change in share value. At the conclusion of that conversion the share or par value of each share was \$50, regardless of whether any shareholder elected to take additional shares in lieu of dividends. That share or par value remained \$50 regardless of when or how many new shares were issued at \$50 each. This value remained unchanged at \$50 even though additional shares were issued in cancellation of dividends.

*American Gas* will be further discussed in connection with the analysis of *U. S. v. Pure Oil Co.*, 135 F. 2d 578, below.

The appellant contends that the *Pure Oil* case is distinguishable from the present one on its facts (Brief p. 23), but that if not distinguishable then the *Pure Oil* case is wrong (Brief p. 25).

The appellant then devotes some considerable space to arguments concerning the correctness of that decision. Perhaps the best answer to this contention is furnished by the statement of the trial judge in his opinion [R. 69] where in reference to *Pure Oil* he said:

The government criticizes this decision, at the same time it did not endeavor to justify its attempted exaction of over \$20,000.00 by applying for a writ of certiorari. It is interesting to note that Circuit Judge Minton, now a member of the Supreme Court of the United States, concurred in said opinion.

An additional statement from the opinion of the trial judge indicates that both this Court and the trial court in the *Southern Pacific* case probably considered that case and *Pure Oil* not in irreconcilable conflict.

In the *Southern Pacific* case Judge Healy did not mention the *Pure Oil* case, which indicates he recog-

nized that factually they were not comparable. The failure to refer to it was intentional as it was cited on another point in the opinion written by Judge Roche in the District Court in *Southern Pacific Co. v. Berliner*, 78 F. Supp. 696-697. [R. 70.]

Further evidence that *Pure Oil* correctly stated the law is the fact that in *American Gas* the Court not only distinguishes *Pure Oil* at pages 619-620, but cites *Pure Oil* with approval at page 618 and intimates that on similar facts it would follow the *Pure Oil* case, at page 620.

The *Pure Oil* case is believed by the appellee to be almost precisely in point here, and the following quotation from the Court's opinion therein sets out the facts and conclusions of law most adequately.

On April 1, 1936, defendant had outstanding certain shares of preferred stock on which there were unpaid accumulated dividends, on 8 per cent stock, of \$25.50 per share, on 6 per cent stock, \$19.125 per share. Defendant proposed, and its shareholders agreed, their certificates be exchanged, share for share, for equal shares of new preferred stock, paying a lower dividend, plus additional shares of new stock in satisfaction of the unpaid dividends. As a result, 264,226 shares of outstanding preferred stock were surrendered and an equivalent number of shares of new preferred delivered to the holders, who received also 56,115 shares of new stock in satisfaction of unpaid dividends.

\* \* \* Defendant recognized that the shares issued in satisfaction of unpaid dividends were within the term "original issue" and paid the tax upon them. The Government contended, and the trial court found, that the certificates for 264,226 shares issued in exchange for outstanding stock constituted likewise an

original issue. The propriety of that conclusion is now questioned.

The statute clearly indicates that, to be taxable, certificates must be, in point of time, the first issued, whereby the issuing corporation certifies ownership by its shareholders of their aliquot parts of the capital represented by the certificates. By specifying "original issue" we think it clear that the Congress did not intend to tax each issue but only that which precedes all other issues subsequently made when original certificates are surrendered and new ones delivered in their place to the same shareholders for no new monetary consideration. *Edwards v. Wabash Railway Co.*, 2 Cir., 264 F. 610. Nor do we think it of any importance whether shares are converted into identical or variant stock or whether preferred is exchanged for common or common for preferred, with resulting differences in rights and privileges, for the test is not whether the reissue is of different type but, rather, whether it is "original".

It was to defendant's interest to liquidate its unpaid accumulated dividends and to bring about a lower dividend for the future. When, with this end in view, defendant issued an equal amount of new stock for that part of the corporate assets represented by previously existing shares, it made no addition to its capital. It accomplished nothing other than replacement of older preferred stock with new, smaller dividend stock; the holders retained the same proportionate interests in the capital assets. The additional shares issued in satisfaction of unpaid dividends represented the only contribution to capital effectuated; that and that alone was an original issue. *Edwards v. Wabash Railway Co.*, 2 Cir. 264 F. 610; *Trumbull Steel Co. v. Routzahn*, D. C., 292 F. 1009; *Routzahn v. Trumbull Steel Co.*, 6 Cir. 300 F. 1006; *West Virginia*



*Pulp & Paper Co. v. Bowers*, D. C., 293 F. 144, affirmed 2 Cir., 297 F. 225, certiorari denied 265 U. S. 584, 44 S. Ct. 459, 68 L. Ed. 1191; *Standard Manufacturing Co. v. Heiner*, D. C., 300 F. 252; *Cuba Railway Co. v. United States*, 60 Ct. Cl. 272; *Cleveland Provision Co. v. Weiss*, D. C., 4 F. 2d 408; *In re Grant-Lees Gear Co., Bankrupt*, D. C., 1 F. 2d 393.

The Government insists that the entries upon the corporate books fail to disclose any shares specifically designated as a substitution for old certificates. It suggests that inasmuch as no shares were issued in lieu of any certain specified shares and no specific certificates charged against capital or surplus, it is impossible to classify the entire new issue as other than original. But book entries alone are not decisive. *Rio Grande Oil Company v. Welch*, 9 Cir., 101 F. 2d 454. And, so here, we receive no enlightenment from the formal ledger capital set-up. The undisputed fact is that the old preferred stock was exchanged share for share and the dividend arrears satisfied by issuance of additional shares. Whatever the book entries, the only new thing that could properly have gone into the capital account was the contribution by the shareholders of their unpaid dividends to the corporation in consideration of which they received the additional shares.

To the appellee the *Pure Oil* case seems almost squarely in point—certainly more nearly so than *Southern Pacific* or *American Gas & Electric Co.* If anything the case of the appellee is somewhat stronger than that of the taxpayer in *Pure Oil* because here the stockholders had the option to take or refuse the additional shares.

The appellant understandably seeks to distinguish the *Pure Oil* case but rather surprisingly asserts that this case differs from *Pure Oil* in the “same material respect



as the facts of *American Gas* differed from those of *Pure Oil*.” (Brief p. 23.)

Appellee quotes herewith the identical quotations from *American Gas* cited by appellant in its brief, pages 23-24:

Plaintiff contends that the transaction here was clearly analogous to the transaction in the *Pure Oil* case. *It says that the only distinction between the two cases is that here plaintiff, instead of using the amount transferred from surplus to capital as the basis for issuing additional shares as a dividend [as was done in Pure Oil], used it as the basis for increasing the capital liability per share from \$94 to \$100; that, in other words, instead of issuing one new share representing the same capital liability of \$94 as the old share, and a separate share representing a capital liability of \$6—as it might have done—it issued a single share representing a capital liability of \$94 plus \$6.*

*But this distinction is important. \* \* \** (Italics supplied.)

\* \* \* \* \*

The fallacy in plaintiff's position is that it takes an average and assumes that each old share exchanged represented a capital liability of \$93.9995 per share. If that were so, the amount transferred from surplus to capital might be treated as a distribution or a dividend, upon each share and an allocation made between the shares issued in payment of such distribution or dividend and the shares issued in exchange for the old stock, as was done in the *Pure Oil* case. But that is impossible here, for the shares as to which such a distribution or dividend might properly be said to have been made cannot be identified and segregated from the others. \* \* \* (Italics supplied by appellant.)

Appellant then correctly interprets the *American Gas* decision as saying that the *Pure Oil* decision concerns in reality two separate transactions and further admits that “perhaps the result in the *Pure Oil* case was correct” because of the ability to identify definite shares issued against the increased capital. (Brief pp. 24-25.) Appellee believes the same ability to identify definite shares as in the *Pure Oil* case exists here.

Appellant then states (Brief p. 25):

On that basis the instant case is certainly to be distinguished from *Pure Oil*, where the Court of Appeals said (p. 579) that the undisputed “fact” was that the old preferred stock was exchanged share for share and the dividend arrears were satisfied by issuance of additional shares—albeit at one and the same time.

Appellant does not then say how our case is to be distinguished from *Pure Oil* or analogized with *American Gas* but rather proceeds to dispute the rationale of the *Pure Oil* case. In other words appellant states that the present case is like *American Gas* rather than *Pure Oil* but instead of *distinguishing* this case from *Pure Oil* proceeds to *attack* the *Pure Oil* case.

Let us return to the portions of the *American Gas* opinion quoted above and see wherein they apply to this case. As pointed out in the italicized portion, the new capital in *American Gas* was *used to increase the capital liability per share from 94 to 100 dollars*. In *Pure Oil* the *capital value per share remained unchanged* and additional shares were issued against the additional capital, thus causing no change in capital value per share. In the present case the capital value of \$50 per share established upon the conversion was not changed one iota by the issuance of additional shares against equivalent

amounts of new capital at the rate of \$50 per share. In other words, the share value of \$50 remained that value, regardless of whether no shareholder accepted the additional stock or whether some or all shareholders accepted the offer.

*American Gas* is also clearly distinguished from the present case in that there, only one transaction was involved and the taxpayer there never even contended otherwise. The argument there was that the tax should be measured only by the increase in capital liability per share (*cf.* above quotation from opinion). There was no such increase in capital liability per share in this case.

Appellee contends that *American Gas* is not in point and furthermore that the same distinctions there pointed out by the Judge between it and *Pure Oil* serve to distinguish *American Gas* from the present case.

As mentioned before briefly, the appellant repeatedly asserts (Brief pp. 9, 14, 20, 26) in slightly varying terminology that the tax must be imposed unless definite or specific shares can be positively identified as having been issued against specific segments of new capital. As authority therefor it quotes three decisions of Circuit Courts and two District Court decisions (Brief p. 9). Careful perusal of the three Circuit Court decisions cited (*Southern Pacific*, *Rio Grande Oil Co.* and *W. T. Grant Co. v. Duggan*, 94 F. 2d 859), does not reveal any such statement as having been made by the Court in any of these cases. (In *Southern Pacific* the Court states something similar as an argument of the Commissioner.) It is conceded that in the two District Court decisions cited (*American Gas* and *Southern Pacific v. Berliner*, 78 Fed. Supp. 696) statements along this line were made. In *Southern Pacific* (District Court) the language was “\* \* \* with-



out any allocation of specific shares to such transferred sum \* \* \*'. (Appellant's Brief p. 17) and in *American Gas* the Court's statement which refers to identification or segregation of shares is immediately preceded, as shown by the above quotation from that case, by the Court's statement that the sort of allocation which the Court had in mind might be made in the *Pure Oil* type of case.

It is worthy of note that in each of the five cases cited by appellant on this point only one transaction admittedly was involved, and in every such case the capital value per share was increased by the new capital. In the only case, *Pure Oil*, where two transactions were involved, as here, and where the capital value per share, as here, was unchanged by the issuance of additional shares, the Court definitely rejected the Commissioner's specific identification argument in the following manner:

It (the Government) suggests that inasmuch as no shares were issued in lieu of any certain specified shares and no specific certificates charged against the capital or surplus it is impossible to classify the entire new issue as other than original.

\* \* \* \* \*

The undisputed fact is that the old preferred stock was exchanged share for share and the dividend arrears satisfied by issuance of additional shares. *Whatever the book entries, the only new thing that could properly have gone into the capital account was the contribution by the shareholders of their unpaid dividends to the corporation in consideration of which they received the additional shares.* (Italics supplied.)

It is respectfully submitted that the Courts have applied the allocation or identification argument so as not to re-



quire specific shares to be identified by number, page and journal entry, but only to require a reasonable identification of a block of shares with a segment of capital. It is the appellee's belief that it has met the burden of proof in this regard inasmuch as the new shares issued in lieu of dividend arrearages can be identified, and exactly the same possibilities of identification exist here as in *Pure Oil*. Indeed the parties have virtually stipulated that such segregation is possible when they stipulated (referring to the conversion of stock by the amendment of the Certificate of Incorporation): "This was the sole and only change made in the *capital structure* by said amendment to the Certificate of Incorporation." [R. 29] and that "\* \* \* such new shares being issued *if, as and when the dividend arrearages were waived, and in exchange therefor.*" [R. 30.] (Italics supplied.)

Perhaps the best answer to the "intermingling" argument of appellant is furnished by analyzing its statement (Brief p. 20), which by virtue of italicizing it apparently considers quite important, in which it says: "Each new preferred stockholder, *regardless of whether he was one of those who had waived his right to the dividend arrearages*, received an interest in the newly augmented capital measured by the number of shares held."

The error of this conclusion is quite apparent, for if no shareholder had consented to accept new shares in lieu of dividends, and they were under no legal compulsion to do so, there would have been no "augmented capital," and even if others consented and one did not, his claim in dollars against the capital account was not changed by so much as one penny. His claim against the capital account was only changed if, as and when he waived dividends and accepted new stock in lieu thereof, and the

change was in exactly the amount of dividends satisfied by the new stock, and in exactly the amount of new capital added by virtue of his waiver.

Finally as to the effect of Congressional attempts to remedy the inequities of such decisions as *American Gas & Electric Co.* and *Southern Pacific Co.*, it is not and never has been the appellee's contention that the amendment to the Internal Revenue Code, Section 1802, effective August 8, 1947, was by its terms retroactive. Appellee does, however, contend that the following language from House Ways and Means Report No. 969 on H. R. 3613, is indicative of an intent to enact remedial legislation:

This bill would amend three sections of the Internal Revenue Code relating to the stamp and document taxes on issues of capital stock and bonds, respectively. In general, it is designed to remove certain inequities arising under code sections 1802 and 3481. At present, in some cases, the tax imposed under section 1802 on capital stock issues, once levied, must be reimposed upon part of a new capital stock issue. . . .

Your committee sees no justification whatever for permitting these inequities to continue. Their removal will greatly simplify present procedures and will have no material effect upon Federal revenues.

Conceding arguendo that this remedial statute has no retroactive application and only the "law" as it stood prior to its correction is to be considered in this case, we are presented with the question, "What is the 'law' in such cases?" Appellant argues that the "law" as expounded in *American Gas & Electric Co.*, *Southern Pacific Co.*, and similar cases *must* be applied to the facts of the present case.

On the other hand appellee contends that the cases cited by appellant in support of its position are all distinguishable on their facts and that the case most nearly in point, *Pure Oil*, supports appellee's position. It should be noted that appellant makes no satisfactory distinction between *Pure Oil* and the present case but contents itself with the claim that *Pure Oil* is incorrect on the law. The best then that can be said for appellant's position is that in some jurisdictions cases with somewhat similar (but distinguishable) facts have been decided in its favor, while in another jurisdiction, upon facts almost precisely in point, the "law" was found to be in favor of the taxpayer. It is also worthy of note that the Bureau of Internal Revenue did not apply for certiorari in *Pure Oil* in order to resolve the "conflict" in law, if any there be. Appellee contends that *Pure Oil* is the "law" on these facts.

However, granting *arguendo* that the "law" is uncertain, then it is appellee's respectful contention that in cases of such uncertainty that reasonable minds and courts have differed, that the law, as applied in certain cases, which Congress has found to be inequitable, should not be extended beyond those cases to which it is clearly applicable. The present case on its facts, as hereinabove set forth, is not such a case.

In any event, regardless of the remedial legislation, appellee contends that the facts of this case bring it within the ambit of the *Pure Oil* case and place it outside that of *Southern Pacific*.

Conclusion.

The decision of the District Court is correct and should be affirmed.

Respectfully submitted,

DEMPSEY, THAYER, DEIBERT & KUMLER,  
THOMAS R. DEMPSEY,  
WELLMAN P. THAYER,  
ARTHUR H. DEIBERT,  
WILLIAM L. KUMLER,

*Counsel for Appellee.*

HENRY W. COIL,  
*Associate Counsel.*



No. 12612

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

ERWIN P. WERNER,

Appellant.

vs.

UNITED STATES OF AMERICA,

Appellee.

---

Transcript of Record

---

Appeal from the United States District Court,  
Southern District of California,  
Central Division.

FILED

OCT - 4 1950

PAUL P. O'BRIEN,  
CLERK



No. 12612

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

ERWIN P. WERNER,

Appellant.

vs.

UNITED STATES OF AMERICA,

Appellee.

---

Transcript of Record

---

Appeal from the United States District Court,  
Southern District of California,  
Central Division.





## INDEX

---

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

	PAGE
Action for Reformation of Lease and Reasonable Rental for Use and Occupation of Land .....	2
Exhibit A—Lease.....	7
Appellant's Designation of Record on Appeal	33
Certificate of Clerk.....	34
Designation of Points.....	35
Memorandum of Decision.....	24
Names and Addresses of Attorneys.....	1
Notice of Appeal.....	32
Notice of Special Appearance of, and Motion to Dismiss by, the United States of America and Points and Authorities.....	18
Order for Dismissal.....	31
Request to Print Record.....	36



## NAMES AND ADDRESSES OF ATTORNEYS

For Appellant:

ERWIN P. WERNER,  
611 Carlton Way,  
Los Angeles 28, Calif.

For Appellee:

ERNEST A. TOLIN,  
United States Attorney,

IRL D. BRETT,  
Special Assistant to the Attorney General,  
600 U. S. Post Office & Court House  
Bldg., Los Angeles 12, Calif.

United States District Court, Southern District  
of California, Central Division

No. 10539-C

ERWIN P. WERNER,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

ACTION FOR REFORMATION OF LEASE  
AND REASONABLE RENTAL FOR USE  
AND OCCUPATION OF LAND

Comes Now Plaintiff and, for several causes of  
action, alleges as follows:

First Cause of Action

I.

That, at all times herein mentioned, Plaintiff has  
been, and now is, a resident of the County of Los  
Angeles, State of California, and at all times has  
been, and now is, a citizen of the United States.

II.

That the United States District Court has juris-  
diction over this litigation by reason of the fact  
that the Defendant is the United States of America  
and the Plaintiff is a citizen of said country.

III.

That at all times herein mentioned the Plaintiff  
has been, and now is, the legal owner in fee, and  
entitled to possession and enjoyment of that certain



parcel of land situated in Riverside County and consisting of forty acres, which is more particularly described as follows:

The southeast (SE) one-quarter ( $\frac{1}{4}$ ) of the southeast (SE) one-quarter ( $\frac{1}{4}$ ) of Section Sixteen (16), Township Three (3) South, Range four (4) West, S.B.B. & M. continuing forty (40) acres more or less.

#### IV.

That prior to the 1st day of February, 1943, the above-described property was placed and held in trust by Mark L. Herron and Barbara Herron, his wife, as trustees, with directions and upon the understanding that said property would be returned to the Plaintiff herein, upon Plaintiff's request.

#### V.

That on or about the 1st day of February, 1943, and while said land was so held in trust by the said Mark L. Herron and his wife, Barbara, as trustees, as aforesaid, a lease of said land was made and entered into by and between said trustees, as lessor, with the United States of America, as lessee, copy of said lease being attached hereto and made a part hereof and being marked "Exhibit A." That said lease was prepared by the United States of America, Defendant. That the United States of America, under the terms and conditions of said lease, agreed to pay to the lessor, or his assigns, a rental in the sum of \$25.00 per year, payable from execution of the lease and to continue thereafter until the termination of the "unlimited national emergency,"

as declared by the President of the United States on May 27, 1941, by Proclamation 2487. That, by and through a mutual mistake of Plaintiff and Defendant, as hereinafter set forth, said lease did not and does not now truly state or express the intention of the said parties.

## VI.

That at the time of issuance of the said Presidential Proclamation, heretofore referred to, the defendant Government was then in a state of war with enemies then unknown, but at the date of the execution of the said lease the Defendant was engaged in actual warfare with the foreign nations of Italy, Germany and Austria, and the Imperial Government of Japan, which constituted the "Axis belligerents" referred to in said proclamation. That, on the 1st day of February, 1943, it was therefore the mutual understanding of the parties to this agreement that by the use of the words in said lease, namely, "that said lease shall in no event extend beyond six months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27, 1941 (Proclamation 2487)," was meant in their ordinary and popular sense to mean and was, on the date of the execution of said lease, understood to be, "six months from the date of the cessation of actual hostilities with the said Axis nations then at war, or the surrender of said Axis nations," which surrender finally occurred on the 14th day of August, 1945; that in truth and in fact, on the 31st day of December, 1946, it was declared

by proclamation of the President of the United States, Proclamation 2714, that "there was the cessation of hostilities of World War II."

## VII.

That until the reconveyance to Plaintiff of said real property, as aforesaid, the terms and conditions of said lease agreement and mutual mistake were unknown to the Plaintiff herein, until June 14, 1948, when a copy of said lease was delivered to Plaintiff by said trustees. That immediately since that time and upon the said discovery of the said mutual mistake, the Plaintiff has demanded that Defendant reform said lease and correct the said mutual mistake, but Defendant has at all times herein mentioned refused to do so.

## VIII.

Plaintiff alleges that said real property has a fair market value of approximately \$20,000.00; and that it is grossly unjust, unfair and inequitable for the said Defendant to assert any right, title or interest in and to said contract lease, under its present terms and conditions, as it must be presumed that the parties hereto intended to make an equitable and conscientious agreement and lease of said real property.

### Second Cause of Action

#### I.

Plaintiff incorporates paragraphs I, II, III, IV, V, VI, VII and VIII of the first cause of action and makes them a part of this, his second cause of



action, the same as though separately set forth herein.

## II.

That said lease was terminated on the 14th day of August, 1945, by reason of the said cessation of hostilities on the part of the said Axis nations; that ever since said date of August 14, 1945, the Defendant has been in actual possession and enjoyment of the said real property. Plaintiff further alleges that the fair market value of said land is \$20,000.00.

## III.

That the use of said real property for said period was reasonably worth \$2,500.00 per year; that the Defendant has not paid said sum or any part thereof.

Wherefore, Plaintiff prays judgment against the Defendant as follows:

1. That by decree of this court the hereinabove mentioned lease dated 1st day of February, 1943, be reformed to conform with the actual intention of the parties.

2. For the reasonable value of the use and occupation of said real property occupied by Defendant since the 14th day of August, 1945.

3. For such other and further relief as to the court may seem proper.

/s/ MILAN MEDIGOVICH,  
Attorney for Plaintiff.

/s/ ERWIN P. WERNER,  
In Propria Persona.



EXHIBIT A

U. S. Standard form No. 2 (revised)

Copy

Lessor

Lease

Between Mark L. Herron and Barbarra W. Herron and the United States of America.

1. This Lease, made and entered into this first day of February in the year one thousand nine hundred and forty three by and between Mark I. Herron and Barbarra Herron, husband and wife whose address is 1025 Chapman bldg, Los Angeles, California. for themselves, their heirs, executors, administrators, successors, and, assigns, hereinafter called the lessor, and the United States of America, hereinafter called the government:

Witnesseth: The parties hereto for the consideration hereinafter mentioned covenant and agree as follows:

2. The lessor hereby leases to the Government the following described premises, viz:

All of that parcel of land in the Alessandro District, County of Riverside, State of California, described as:

The Southeast quarter (SE $\frac{1}{4}$ ) of the South east quarter (SE $\frac{1}{4}$ ) of Section 16, Township 3 South, Ranges 4 West, S.B.B. & M., containing forty acres, more or less.

(rubber stamp) The supplies and services to be obtained by this instrument are authorized by, are the purpose set forth in, and (unreadable) procurement authority.

8-30068 p 330-05 A 0905- 24

.....  
the available balance of which is sufficient to cover the cost of same

to be used exclusively for the following puposes  
(see instrucion 3: Military purposes.

3. To Have and to Hold the said premises with their appurtanances for the term beginning February 1, 1943 and ending with June 30, 1943

MLH

BWH

negotiated lease

4. The government shall not assign this lease in any event, and shall not sublet the premises except to a desirable tenant, and for a similar purpose, and will not permit the use of said premises by anyone other than the government, such sublessee, and the agents and servants of the Government, or of such sublessee.

5. This lease may, at the option of the government, be renewed from year to year at a rental of

Twenty-five and no/100 (\$25.00) per year and otherwise on the terms and conditions herein specified, provided notice be given in writing to the lessor at least thirty days (30 before this lease

or any renewal thereof would otherwise expire; provided that no renewal thereof will extend the period of occupancy of the premises beyond six (6) months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27th, 1941, (Proclamation 2487).

6. The lessor shall furnish to the Government, during the occupancy of said premises, under the terms of this lease, as part of the rental consideration, the following:

Nothing.

7. The Government shall pay the lessor for the premises rent at the following rate:

Twenty-five and no?100 Dollars (\$25.00) per year, or prorata amount for ffactional period of use thereof.

Finance officer, U.S. Army, Port Douglas, Utah, is deignated to pay this rental.

Payment shall be made at the end of each fiscal year.

8. The Government shall have the right, during the existance of this lease, to make alterations, attach fixtures, and erect additions, such alterations, additions, structures, or signs shall not be detrimental, to or inconsistent with the rights granted to other tenants on the property or in the building in which said premises are located); which additions, fixtures, or structures so placed in or upoun

or attached to the said premises shall be and remain the property of the Government and may be removed therefrom by the Government prior to the termination of this lease, and the Government, if required by the lessor, shall, before the expiration of this lease or renewal thereof, reestor the premises to the same condition as that existing at the time of entering upoun the same under this lease, reasonable and ordinary ware and tear and damages by the elements or by circumstances over which the Government has no control, excepted: Provided, however, that if the lessor requires such restoration, the lessor shall give written notice thereof to the Government twenty days (20) before the termination of this lease.

9. (cancelled)

10. (cancelled)

11. No member of or delegate to Congress or resident commissioner shall be admitted to any share or part of this lease or to any benefit to arise therefrom. Nothing, however, herein contained shall be construed to extend to any incorporated company, if the lease be for the general benefit of such corporation or company.

12. The Government reserves the right to cancel this lease at any time during its life or renewal thereof by giving thirty days (30) advance written notice to the lessor.

13. The condition of the demised premises is outlined in a joint Record of Physical Survey which is appended hereto and made a part hereof.



Paragraphs 9 and 10 deleted, and Paragraphs 12 and 13 added prior to execution hereof,

MLH

BWH

In Witness Whereof, the parties hereto have hereunto set and subscribed their names as of the date first above written.

MARK L. HERRON

MARK L. HERRON, and

BARBARA W. HERRON

BARBARA W. HERRON,

husband and wife

Lessor

UNITED STATE OF AMERICA

By THOMAS F. CROGAN

Chief, Los angeles Sub-office

Official title

Contracting officer.

INEZ M. KEMPER

INEZ M. KEMPER

2020 Beachwood Dr.

(Address)

Hollywood, Calif.

(If the lessor is a corporation, the following certificate shall be executed by the secretary as assistant secretary.)

L, ....., certify that I am the .....  
Secretary of the corporation named as Lessor in  
the attached lease: that ....., who signed  
said lease on behalf of the Lessor, was then

..... of said corporation: that said lease was duly signed for and in behalf of said corporation by authority of its governing body, and is within the scope of its corporate powers.

.....

[Corporate Seal.]

Instructions to Be Observed in Executing Lease

1. This standard form of lease shall be used whenever the Government is the lessee of real property; except that whenever the total consideration does not exceed \$100 and the term of the lease does not exceed one year the use of this form is optional. In all cases where the rental to be paid exceeds \$2,000. per annum the annual rental shall not exceed 15 per centum of the fair market value of the rented premise at the date of the lease. Alterations, improvements, and repairs of the rented premises by the Government shall not exceed 25 per centum of the amount of the rent for the first year of the rental term or for the rental term if less than one year.

2. The lease shall be dated and the full name and address of the lessor clearly written in paragraph 1.

3. The premises shall be fully described, and, in case of rooms, the floor and room number of each room given. The language inserted at the end of article two of the lease should specify only the general nature of the use, that is, "office quarters," "storage space," etc.

4. Whenever the lease is executed by an attorney, agent, or trustee on behalf of the lessor, two authenticated copies of his power of Attorney, or other evidence to act on behalf of the lessor, shall accompany the lease.

5. When the lessor is a partnership, the names of the partners composing the firm shall be stated in the body of the lease. The lease shall be signed with the partnership name, followed by the name of the partner signing the same.

6. Where the lessor is a corporation, the lease shall be signed with the corporate name, followed by the signature and title of the officer or other person signing the lease on its behalf, duly attested and, if requested by the Government, evidence of his authority so to act shall be furnished.

7. Under paragraph 6 of the lease insert necessary facilities to be furnished, such as heat, light, janitor service, etc.

8. There shall be no deviation from this form without prior authorization by the Director of Procurement, except-

(a) Paragraph 3 may be drafted to cover a monthly tenancy or other period less than a year.

(b) In paragraph 5, if a renewal for a specified period other than a year, or for a period optional with the Government is desired, the phrase "from year to year" shall be deleted and proper substitution made. If the right of renewal is not desired or cannot be secured paragraph 5 may be deleted.

(c) Paragraph 6 may be deleted if the owner is not to furnish additional facilities.

(d) If the premises are suitable without alterations, etc., par. 8 may be deleted.

(e) Par. 9 provides that the lessor shall, "unless herein specified to the contrary, maintain the premises in good order, etc. A modification or elimination of this requirement would not therefore be a deviation.

(f) In case the premises consist of unimproved land, par 10 may be deleted.

(g) When executing leases covering premises in foreign countries, departure from the standard form is permissible to the extent necessary to conform to local laws, customs or practices.

(h) Additional provisions, relating to the particular subject matter mutually agreed upon, may be inserted, if not in conflict with the standard provisions, including a mutual right to terminate the lease upon a stated number of days' notice, but to permit only the lessor so to terminate would be a deviation requiring approval as above provided.

9. When deletions or other alternations are permitted specific notation thereof shall be entered in the blank space following par 11 before signing.

10. If the property leased is located in a state requiring the recording of leases in order to protect the tenants rights, care should be taken to comply with all such statutory requirements.



CR Form 208

No. W2972 Eng 1450

Copy

Supplemental Agreement to Dispense with  
Notice of Renewal.

This Supplemental Agreement entered into this 31st day of May, 1943, by and between Mark L. Herron and Barbara Herron, husband and wife, whose address is 1025 Chapman Building, Los Angeles California for themselves, their heirs executors, administrators, successors, and assigns, hereinafter called the lessors, and the United State Government, hereinafter called the Government, Witnesseth:

Whereas on February 1, 1943, a lease was entered into between the lessor and the Government covering all of that Southeast (SE)  $\frac{1}{4}$  of the south-east quarter (SE $\frac{1}{4}$ ) of section 16, Township 3 South, Range 4 West, S.B.B. & M., containing forty acres, more or less. Being located in the Alesandro District of the County of Riverside, State of California. for a period February 1, 1943, to June 30, 1943, with option of renewal annually thereafter to six months from the date of the termination of the unlimited National Emergency, as declared by the president of the United States on May 27, 1941, (Proclamation 2487).

Whereas it is desired to amend said lease to dispense with the service of notice of renewal for each fiscal year, as hereinafter provided;

Now, Therefore, the parties hereto do hereby amend said lease in the following respects only:

1. Provisions 3 and 5 are deleted, and there is inserted in lieu thereof the following provision numbered 3:

“3. To Have and to Hold the said premises with their appurtenances for the term beginning July 1, 1943 through June 30, 1944, provided that, unless and until the Government shall give notice of termination in accordance with provision 12 hereof, this lease shall remain in force thereafter from year to year without further notice; provided further that adequate appropriations are available from year to year for the payment of rentals; and provided further that this lease shall in no event extend beyond six months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27, 1941, (Proclamation.”

In Witness Whereof, the parties hereto have executed this instrument as of the day and year first above written.

MARK L. HERRON

MARK L. HERRON

BARBARA W. HERRON

BARBARA W. HERRON

Lessor.

THE UNITED STATES OF  
AMERICA

By THOMAS F. CROGHAN

(Contracting officer)

Thomas F. Croghan, Chief,  
Los Angeles Sub-office.

Witness:

INEZ M. KEMPER

INEZ M. KEMPER

2020 Beachwood Dr.  
Hollywood Cal.

State of California,  
County of Los Angeles—ss.

Erwin P. Werner, being by me first duly sworn, deposes and says: that he is the Plaintiff in the above entitled action; that he has read the foregoing Action for Reformation of Lease and Reasonable Rental for Use and Occupation of Land and knows the contents thereof; and that the same is true of his own knowledge, except as to the matters which are therein stated upon his information or belief, and as to those matters he believes it to be true.

/s/ ERWIN P. WERNER

Subscribed and sworn to before me this 8th day of November, 1949.

[Seal] /s/ W. E. SCHREYER,

Notary Public in and for Said County and State of California.

[Endorsed]: Filed November 8, 1949.

[Title of District Court and Cause.]

NOTICE OF SPECIAL APPEARANCE OF,  
AND MOTION TO DISMISS BY, THE  
UNITED STATES OF AMERICA AND  
POINTS AND AUTHORITIES

To: Plaintiff, Erwin P. Werner, and to Milan  
Medigovich, Esq., his attorney:

You and Each of You Will Please Take Notice that on Monday, April 3, 1950, at the hour of 10:00 o'clock a.m., or as soon thereafter as counsel may be heard, in the Courtroom of the Honorable James M. Carter, Judge thereof, Room No. 3, Second Floor, Courthouse and Postoffice Building, Los Angeles, California, defendant, United States of America, will appear specially and solely for the purpose of such motion, and not otherwise, and move this Honorable Court to dismiss the Complaint herein.

Said motion will be made upon the following grounds:

1. That the United States has not consented to, or submitted to, the jurisdiction of this Court in equity proceedings and the exercise of jurisdiction to reform a written lease is the exercise of equitable jurisdiction and such remedy is an equitable remedy.

2. That the Complaint fails to state claim upon which relief can be granted as against the United States of America, in the following particulars:

- a) The Complaint seeks to obtain through this Court, the equitable remedy of reformation of a



written contract entered into between the United States of America and predecessors in interest of plaintiff; that it does not disclose, expressly or by implication, any restriction upon the right of such predecessors in interest to enter into such lease as written;

b) That although the Complaint alleges that the lessors to the United States were Mark L. Herron and Barbara Herron, his wife, and that they held title to the premises as trustees, it does not allege:

(1) For whom they were trustees;

(2) That there was any restriction upon their right to lease the premises;

(3) That the United States had any knowledge of the trust or of its terms or conditions;

(4) How said trustees could have held title to the property and, at the same time, plaintiff could have been the legal owner in fee and entitled to the possession and enjoyment thereof;

c) That the Complaint does not allege when or how or by whom the property which is the subject matter of the lease, was reconveyed to plaintiff;

d) That the Complaint does not allege how or in what manner the lease could have been executed by and through a mutual mistake of the plaintiff (who is not a party to the lease) and the defendant;

e) The Complaint, together with the exhibits annexed thereto, discloses that the language used in the lease, and in the supplemental modification thereof, is explicit and unambiguous and refers to and in-

cludes the terms and provisions of a presidential proclamation which is, in turn, explicit and unambiguous; that the lease was made on behalf of the United States by Army officials, whose contracts could only be made in writing and who could only bind the United States by a written contract;

f) The contract of lease being for a fixed fee, such is the measure of the compensation for which the United States is liable and it is not liable in quantum meruit;

g) There is no allegation in the Complaint that the rental fixed by the lease has not been paid to, and received by, the lessors therein named;

h) There is no allegation in the Complaint as to why, assuming that the lessors were trustees and agents of the plaintiff, the knowledge of such agents should not be imputed to the plaintiff and, in view of such imputation of knowledge, plaintiff is guilty of laches.

Said motion will be based upon the records and files in this proceeding and the statutory and case law applying thereto.

Dated: March 21, 1950.

ERNEST A. TOLIN,  
United States Attorney.

IRL D. BRETT,  
Special Assistant to the  
Attorney General.

By /s/ JOSEPH F. MacPHERSON,  
Attorneys for Defendant.

Points and Authorities  
General

Rule 12 (b) (1) (2) and (6)

1.

Reformation of instruments is peculiarly an equitable remedy.

Black v. Richfield Oil Corp. (CCA 9) 146  
Fed. (2) 801.

2.

Except as Congress has consented, there is no jurisdiction in any Court to entertain claims against the United States.

U. S. v. Sherwood, 312 U.S. 584, 587-588, 85  
L. ed. 1058, 1062.

3.

Such statutes which relinquish sovereign immunity must be strictly construed.

United States v. Sherwood, 312 U.S. 584, 590,  
85 L. ed. 1058, 1063.

4.

The United States has not consented to suits in equity against it.

Harvey v. United States, 105 U.S. 671, 26  
L. ed. 1206, 1209.

Rambo v. United States (CCA 5), 145 Fed.  
(2) 670.

## 5.

While the Tucker Act (28 U.S.C., Sec. 41, subsec. 20) was construed to include the equitable jurisdiction to reform contracts of the United States for payment of money (Cf. *U.S. v. Milliken*, 202 U.S. 168, 173-174; 50 L. ed. 980, 982-983; *Cramp v. U.S.*, 239 U.S. 221, 230; 60 L. ed. 238, 242) that statute has been amended to delete the reference to equity: 28 U.S.C. (Rev.) Sec. 1346.

## 7.

A trustee hold the legal title.

*Lincoln v. French*, 105 U.S. 614; 26 L. ed. 1189.

25 Cal. Jur. "Trusts," § 165, p. 314.

*Brichette v. Raney*, 76 Cal. App. 232, 248, 245 Pac. 235.

## 8.

A trustee is an agent. Civil Code, Sec. 2267.

## 9.

Knowledge of agent within the apparent scope of the agency is imputed to principal.

Civil Code, Sec. 2300.

Civil Code, Sec. 2332.

## 10.

Public officers have no ostensible authority as agents of the United States.

*Whiteside v. United States*, 93 U.S. 247, 23 L. ed. 882.



11.

Contracts for the United States by Army officers must be in writing.

Harper v. United States (CCA 5), 10 Fed. (2) 150, 151.

Rev. Stat. §§ 3744, 3746.

Comp. Stat. § 6895, § 6898.

12.

The lease, the supplemental lease and Presidential Proclamations.

No. Pac. Ry. v. United States, 70 Fed. Supp. 836, 850.

Proclamation #2487, Code Fed. Reg.

Cumulative Supp., Title 3, p. 234.

Proclamation #2714, C.F.R. 1946, Title 3, p. 77.

Affidavit of Service by Mail—1013a, C.C.P.

State of California,

County of Los Angeles—ss.

Julia Westover, being first duly sworn deposes and says:

That affiant is a citizen of the United States and a resident of the County of Los Angeles; that affiant is over the age of 18 years and is not a party to the within and above-entitled action; that affiant's business address is 807 Federal Building, Los Angeles 12, California.

That on the 21st day of March, 1950, affiant served the within Notice of Special Appearance of, and

Motion to Dismiss by, the United States of America and Points and Authorities on the plaintiff in said action, by placing a true copy thereof in an envelope addressed to the attorney for plaintiff at the business address of said attorney as follows: Mr. Milan Medigovich, Attorney at Law, 1215 Transamerica Building, 649 South Olive Street, Los Angeles 14, California, and by then sealing said envelope and depositing the same, with postage thereon fully prepaid, in the United States Post Office at Los Angeles. That there is delivery service by United States mail at the place so addressed and there is a regular communication by mail between the place of mailing and the place so addressed.

/s/ JULIA WESTOVER.

Subscribed and sworn to before me this 21st day of March, 1950.

[Seal]      /s/ ALBERT N. MINTON,  
Notary Public in and for  
Said County and State.

[Endorsed]: Filed March 21, 1950.

---

[Title of District Court and Cause.]

#### MEMORANDUM OF DECISION

This case is before the court on motion of the United States to dismiss plaintiff's "action for reformation of lease and reasonable rental for use

and occupation of land" in Riverside County, California.

The material facts as alleged in the complaint are these. Prior to February 1, 1943, the land involved "was placed and held in trust by Mark L. Herron and \* \* \* wife, as trustees, with directions and upon the understanding that said property would be returned" to plaintiff upon demand.

On February 1, 1943, the trustees, as lessor, and the United States, as lessee, entered into a lease of the land for one year at a rental of \$25, with option granted to the lessee to renew from year to year "provided that no renewal thereof will extend the period of occupancy \* \* \* beyond six (6) months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27th, 1941 (Proclamation 2487)." [See 3 Code Fed. Regs. 234 (Cum. Supp. 1943).]

Plaintiff further alleges that the words of the provision just quoted were intended "in their ordinary and popular sense to mean" and were, "on the date of the execution of said lease, understood to be 'six months from the date of cessation of actual hostilities with \* \* \* or the surrender of said Axis nations,' which surrender finally occurred on the 14th day of August, 1945; \* \* \* [and] on the 3rd day of December, 1946, it was declared by proclamation of the President of the United States, Proclamation 2714, that 'there was the cessation of hostilities of World War II.' " [See 3 Code Fed. Regs. 77 (Supp. 1946).]



For a second cause of action plaintiff alleges that "said lease was terminated on the 14th day of August, 1945"; that the lessee has since had the use of the property, which "for said period was reasonably worth \$2500.00 per year." The prayer is for reformation of the lease "to conform with the actual intention of the parties," for recovery of "the reasonable value of the use and occupation of said real property \* \* \* since the 14th day of August, 1945," and for general relief.

Defendant's motion to dismiss asserts two defenses [Fed. R. Civ. P. 12 (b), (g), (h); see *Orange Theatre Corp. v. Rayherstz Amusement Corp.*, 139 F. 2d 871 (3rd Cir. 1944)]: (1) lack of jurisdiction over the person of the defendant [Fed. R. Civ. P. 12 (b) (2)], the ground asserted being "that the United States has not consented to, or submitted to, the jurisdiction of this court in equity proceedings"; and (2) failure to state a claim upon which relief can be granted [Fed. R. Civ. P. 12 (b) (6)].

It is settled of course that "suits against the United States can be maintained only by permission, in the manner prescribed and subject to the restrictions imposed." [*Munro v. United States*, 303 U.S. 36, 41 (1938); see, also, *Great Northern Life Ins. Co. v. Read*, 322 U.S. 47, 53-54 (1944); *Reid v. United States*, 211 U.S. 529, 538 (1909).] By the Tucker Act [24 Stat. 507 (1887), as amended, 28 U.S.C. § 41 (20) (1946)], the United States of America, as sovereign, consented to be sued in this court on "all claims not exceeding \$10,000 founded \* \* \* upon any contract, express or implied, with the Government of the United States \* \* \* in respect



to which claims the party would be entitled to redress against the United States, either in a court of law, equity, or admiralty, if the United States were suable. \* \* \*

The consent thus granted by the Congress was construed to include suits in equity for reformation of contracts of the United States for payment of money. [See *United States v. Milliken Imprinting Co.*, 202 U.S. 168, 173-174 (1906); *Ackerlind v. United States*, 240 U.S. 531, 534 (1916); *Cramp v. United States*, 239 U.S. 221, 230 (1915).] However, the Government points to the fact that the statute "has been amended to delete the reference to equity." [See 28 U.S.C. § 1346(a) (2) (1948).] Omission by the revisers of Title 28 of the former reference to "equity," it is argued, constitutes in effect a withdrawal by the Government of consent to be sued in this court for equitable relief.

But the reviser's notes to § 1346 of new Title 28 seem to anticipate that argument with the explanation that: "The words 'in a civil action or in admiralty,' in subsection (a) (2), were substituted for 'either in a court of law, equity, or admiralty' to conform to Rule 2 of the Rules of Civil Procedure for the United States District Courts." [28 U.S.C.A. notes following § 1346 (1950).] Similar explanation for like amendments is to be found in the reviser's notes to §§ 1331, 1332, 1335, 1338, 1341, 1342, 1343, 1345, 1347, 1399, 1400, 1441, 2072 and 2073. [See 28 U.S.C.A. notes following the sections cited (1950).] Rule 2 of the Federal Rules of Civil Procedure declares: "There shall be one

form of action to be known as 'civil action.' ” The notes to Rule 2 explain: “Reference to actions at law or suits in equity in all statutes should now be treated as referring to the civil action presented in these rules.” [28 U.S.C.A. § 723c notes following Rule 2 (1941); and see *United States v. Sherwood*, 312 U.S. 584 (1941); *United States v. Gallagher*, 151 F. 2d 556 (9th Cir. 1945); 48 Stat. 1064 (1934), 28 U.S.C. § 723c (1946).]

As amended upon revision “to conform to Rule 2,” 28 U.S.C. § 1346 (a) (2) now reads: “The district courts shall have original jurisdiction, concurrent with the Court of Claims, of \* \* \* any \* \* \* civil action \* \* \* against the United States, not exceeding \$10,000 in amount, founded \* \* \* upon any express or implied contract with the United States. \* \* \*” And the Supreme Court has recently held that the phrase “any civil action” used in the revision of Title 28 “means what it says.” [*Kilpatrick v. Texas & Pac. Ry.*, 337 U.S. 75, 77 (1949).]

Accordingly it must be concluded that omission of the word “equity” from § 1346 (a) (2) in the revision of Title 28 of the United States Code does not indicate congressional intent to withdraw consent of the sovereign to submit to the equitable jurisdiction of this court in actions involving contracts of the United States. The Government’s motion to dismiss upon that ground must therefore be denied. [cf. *United States v. Aetna Surety Co.*, 338 U.S. 366, 383 (1949); *United States v. Sherwood*, *supra*,

312 U.S. at 590; *United States v. Shaw*, 309 U.S. 495, 501 (1940).]

There is, however, another ground which requires dismissal of plaintiff's action. The time limitations for commencement of actions against the United States under the Trucker Act [See 28 U.S.C. § 41 (20) 1946)] are found in 28 U.S.C. § 2401 (a), which stipulates that: "Every civil action commenced against the United States shall be barred unless the complaint is filed within six years after the right of action first accrues."

Validity of the lease and option to renew in controversy here and the rights of the parties derived therefrom are governed by the law of California where the land is situated and the lease was made. [*United States v. Petty Motor Co.*, 327 U.S. 372, 380, 381 (1946); *United States ex rel TVA v. Powelson*, 319 U.S. 266, 279 (1943); *United States v. Bechtold Co.*, 129 F. 2d 473, 477 (6th Cir. 1942); see, also, *United States v. Westinghouse*, . . . . U.S. . . . . (April 17, 1950); *United States v. Burnison*, 339 U.S. 87 (1950); *Becker v. Submarine Oil Co.*, 55 Cal. App. 698, 204 Pac. 245 (1922); *Restatement, Property* § 395, comment b (1944).] As said in *Reading Co. v. United States*, 268 U.S. 186, 188 (1925):

"The contract is to be construed and the rights of the parties to be determined by the application of the same principles as if the contract were between individuals."

In the case at bar the trustees who made the lease were plaintiff's agents [Cal. Civ. Code §§ 2267,



2300], and their knowledge of the alleged mutual mistake upon which plaintiff's right of action is founded must be imputed to him. [Cal. Civ. Code § 2332.] Plaintiff's right of action must then be held to have first accrued on February 1, 1943, when the lease was made. [See *Goodfellow v. Barritt*, 130 Cal. App. 548, 20 P.2d 740, 743 (1933); cf. *Phelps v. Grady*, 168 Cal. 73, 141 Pac. 926 (1914).] This action was not commenced until November 8, 1949 — more than six years thereafter. Plaintiff's claim is therefore barred by the provisions of 28 U.S.C. § 2401 (a).

This court will dismiss an action against the United States for want of jurisdiction whenever the record discloses the claim is barred, even though the bar of the statute has not been pleaded on behalf of the Government. [See *Munro v. United States*, supra, 303 U.S. at 41; *Finn vs. United States*, 123 U.S. 227, 232-233 (1887); *Edwards v. United States*, 163 F. 2d 268, 269 (9th Cir. 1947); *Gans S.S. Line v. United States*, 105 F. 2d 955, 957 (2d Cir. 1939).]

Plaintiff's action must then be dismissed for want of jurisdiction over the person of the defendant; and it is so ordered.

Counsel for defendant will submit judgment of dismissal accordingly [See Fed. R. Civ. P. 41(b)] pursuant to local rule 7 within five days.

May 26, 1950.

/s/ WM. C. MATHES,

United States District Judge.

[Endorsed]: Filed May 26, 1950.



[Title of District Court and Cause.]

ORDER FOR DISMISSAL

Upon the ground of the legality of jurisdiction over the person of the defendant, the defendant, United States of America, having heretofore appeared specially in this proceeding and solely for the purpose of the Motion made by it, and having regularly moved this Court for an Order dismissing the Complaint herein, said Motion having come on regularly for hearing on Monday, April 3, 1950, at the hour of 10 a. m., in Courtroom No. 2, before the Hon. William C. Mathes, United States District Judge, and the Motion having been submitted upon briefs for consideration and decision, the Court now finds that plaintiff's right of action first accrued on February 1, 1943; that this action was commenced on November 8, 1949, which was more than six years following the date of accrual of such right of action, and that plaintiff's claim is, therefore, barred by the provisions of Title 28, Section 2401(a) U.S.C., and, for such reason, this Court does not have jurisdiction over the person of the defendant, United States of America.

The Court now orders that said Motion for Dismissal be, and it is hereby, granted, and that the cause is hereupon dismissed for want of jurisdiction over the United States.

Dated: This 8th day of June, 1950.

/s/ WM. C. MATHES,

United States District Judge.

Presented by:

ERNEST A. TOLIN,  
United States Attorney.

IRL D. BRETT,  
Special Assistant to the Attorney General,  
Lands Division Department of Justice

By /s/ IRL D. BRETT,  
Attorneys for Defendant.

Approved as to Form Under Rule VII:

.....

MILAN MEDIGOVICH,  
Attorney for Plaintiff.

Judgment entered June 9, 1950.

[Endorsed]: Filed June 9, 1950.

-----

[Title of District Court and Cause.]

### NOTICE OF APPEAL

Notice is hereby given that Erwin P. Werner, plaintiff above, named hereby, appeals to the Circuit Court of Appeals for the Ninth Circuit from that Order of Dismissal and from the judgment entered in this action on June 9, 1950, Book 66, page 411.

Dated: This 12th day of June, 1950.

/s/ ERWIN P. WERNER,  
Proper personam.

[Endorsed]: Filed June 12, 1950.

[Title of District Court and Cause.]

APPELLANT'S DESIGNATION OF  
RECORD ON APPEAL

To the Clerk of the above-entitled Court:

Erwin P. Werner, plaintiff above-named and the appellant herein, hereby designates the entire record before the District Court, including all papers, and pleadings filed with the District Court.

Pursuant to the provisions of Rule 75(o) of the rules of civil procedure for the United States District Courts, and pursuant to United States Court of Appeals for the Ninth Circuit, as amended, request is hereby made that the Clerk of the above-entitled court transmit all the original papers in the file dealing with the action or the proceeding in which the appeal has been taken, including the Notice of Appeal heretofore filed and this designation, together with the Complaint, Motion to Dismiss the Order of Dismissal, and the Judgment entered thereon.

Dated: June 12, 1950.

/s/ ERWIN P. WERNER,  
In proper personam.

[Endorsed]: Filed June 12, 1950.

[Title of District Court and Cause.]

CERTIFICATE OF CLERK

I, Edmund L. Smith, Clerk of the United States District Court for the Southern District of California, do hereby certify that the foregoing pages numbered from 1 to 32, inclusive, contain the original Complaint; Motion to Dismiss; Memorandum of Decision; Order of Dismissal, Notice of Appeal and Designation of Record on Appeal which constitute the record on appeal to the United States Court of Appeals for the Ninth Circuit.

I further certify that my fees for preparing and certifying the foregoing record amount to \$2.00 which sum has been paid to me by appellant.

Witness my hand and the seal of said District Court this 12th day of July, A.D. 1950.

EDMUND L. SMITH,  
Clerk.

[Seal]      By /s/ THEODORE HOCKE,  
Chief Deputy.



[Endorsed]: No. 12612. United States Court of Appeals for the Ninth Circuit. Erwin P. Werner, Appellant, vs. United States of America, Appellee. Transcript of Record. Appeal from the United States District Court for the Southern District of California, Central Division.

Filed: July 14, 1950.

/s/ PAUL P. O'BRIEN,

Clerk of the United States Court of Appeals for the Ninth Circuit.

---

In The United States Circuit Court of Appeals  
For The Ninth District  
No. 10539—WM. Civ.

ERWIN P. WERNER,

Plaintiff and Appellant,

vs.

UNITED STATES OF AMERICA,

Defendant and Respondent.

### DESIGNATION OF POINTS

The points upon which Appellant intends to rely are:

1. Court erred in dismissing plaintiff's complaint on the ground the statute of Limitations caused both actions to lapse.

2. Court erred in not holding that “determination of the unlimited emergency, as declared by the President of the United States on May 27, 1941, (Proclamation 2487,)” ended with the cessation of hostilities by the “Axis Belligerents” August 14, 1945.”

/s/ ERWIN P. WERNER,  
In proper personam.

Affidavit of service by mail attached.

[Endorsed]: Filed July 20, 1950.

---

[Title of Court of Appeals and Cause.]

REQUEST TO PRINT RECORD

To the Clerk:

You are hereby requested to have the entire record on Appeal printed in the above-entitled case.

/s/ ERWIN P. WERNER,  
In proper personam.

Affidavit of service by mail attached.

[Endorsed]: Filed July 20, 1950.

No. 12612

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

ERWIN P. WERNER,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

---

APPELLANT'S OPENING BRIEF.

---

ERWIN P. WERNER,

611 Carlton Way, Los Angeles 28.

*Appellant, In Pro. Per.*





## TOPICAL INDEX

### PAGE

Facts .....2

Point I. When reformation is incidental to the main cause of action, the statute of limitations does not run until the main cause of action is barred..... 9

The statute does not commence to run until the discovery of the mistake ..... 11

Point II. The reformation here merely asks the court to determine what the instrument was intended to mean..... 12

Point III. The court below erred in not holding the contract lease terminated on the "cessation of hostilities"..... 12

Point IV. The words of a contract are to be construed and understood in their ordinary and popular sense..... 13

## TABLE OF AUTHORITIES CITED

CASES	PAGE
Blaney, Ex parte, 184 P. 2d 901.....	15
Carman v. Athern, 77 Cal. App. 2d 595.....	11
Cutting, F. P., v. Peterson, 164 Cal. 44.....	12
Gardner v. Guarantee Co., 137 Cal. 75.....	11
Hoover v. San Defer, 25 Wash. 2d 791, 171 P. 2d 1009.....	15
Hutchinson v. Ainsworthy, 73 Cal. 455.....	9
Kaiser v. Hopkins, 6 Cal. 2d 537, 58 P. 2d 1278.....	15
Lapyre v. United States, 84 U. S. 191.....	13
McClurg v. Phillips, 49 Mo. 315.....	10
Meyer v. Van Collem, 7 Abb. Pr. 222.....	10
Muir v. Louisville & N. R. R. Co., 247 Fed. 888.....	14
Samuels v. United Seamen Service, 165 F. 2d 409.....	13
South Tule, etc. Ditch Co. v. King, 144 Cal. 455.....	10
State ex rel. v. Listman, 157 Wash. 229, 288 Pac. 913.....	15
Stinson v. New York Life, 167 F. 2d 233.....	14
The Three Friends, 166 U. S. 1.....	14
United States v. Anderson, 76 U. S. 56.....	15
United States v. Cain, 72 Fed. Supp. 897.....	13
Wood v. Beach, 156 U. S. 548.....	13

### STATUTES

Civil Code, Sec. 1644.....	13
Civil Code, Sec. 1648.....	13
Civil Code, Sec. 3401.....	12
Code of Civil Procedure, Sec. 338.....	11
Presidential Proclamation 2487 (May 27, 1941).....	5, 12
Presidential Proclamation 2714 (Dec. 3, 1945).....	7
Tucker Act (28 U. S. C. (Rev.), Sec. 1346).....	1
United States Code, Title 28, Sec. 2401(a).....	4

### TEXTBOOKS

22 California Jurisprudence, p. 723, par. 11.....	9
Corwin, The President Office and Powers, p. 363 of notes.....	14
Federal Register, Doc. No. 46-22110.....	8

No. 12612

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

ERWIN P. WERNER,

*Appellant,*

*vs.*

UNITED STATES OF AMERICA,

*Appellee.*

---

## APPELLANT'S OPENING BRIEF.

---

This is an appeal from the District Court, from an order of dismissal. The court refused to allow an amendment.

The complaint is in two causes of action, the first [Tr. 2] cause of action is for reformation of a lease contract, and the second cause is against the United States for money as compensation for the reasonable value for the use and occupation of land, which was the basis of the original lease. The District Court had jurisdiction of the cause by reason of the Tucker Act, 28 U. S. C. (Rev.), sec. 1346.

### Facts.

The material facts alleged in the first cause of action are these [Tr. 2]: Prior to February 1, 1943, the land involved "was placed and held in trust by Mark L. Herron and \* \* \* wife, as trustees, with directions and upon the understanding that said property would be returned" to plaintiff on demand [Tr. 3].

On February 1, 1943, the trustees, as lessor, and the United States, as lessee, entered into a lease of the land for one year at a rental of \$25.00, with the option granted to the lessee to renew from year to year "provided that no renewal thereof will extend the period of occupancy \* \* \* beyond six (6) months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27th, 1941 (Proclamation 2487)." [Tr. 3.]

Plaintiff further alleges that the words just quoted were intended "in their ordinary and popular sense to mean" and were, "on the date of the execution of said lease, understood to be 'six months from the date of the cessation of hostilities with \* \* \* or the surrender of said Axis nations,' which surrender finally occurred on the 14th day of August, 1945 \* \* \* (and) on the 3rd day of December, 1946, it was declared by proclamation of the President of the United States, proclamation 2714, that 'there was a sessation of hostilities of World War II.' "

The second cause of action is for money for the use and occupation of the aforesaid property after the termination of the lease up to the date of the filing of the com-



plaint, November 8, 1949. The gist of the action is found in paragraph 11 on Transcript page 6.

“That said lease was terminated on the 14th day of August, 1945, by reason of the cessation of hostilities on the part of the Axis nations; that ever since said date of August 14, 1945, the defendant has been in actual possession and enjoyment of the said real property, that the defendant has paid no sum for said use.”

The prayer is for

1. For reformation;
2. For the reasonable value of the use and occupation of said land.

The court below in its order for dismissal treats the complaint as one cause of action for the reformation of a contract as the main issue without reference to the second cause of action for the recovery of rent. The reverse is true to-wit: The action is for the recovery of money for the use and occupation of land, with the request for reformation as incidental. We quote from the order of dismissal [Tr. 31]:

“the court now finds that the plaintiff's right of action first accrued on February 1st, 1943; that this action was commenced on November 8, 1949, which is six years following the date of accrual of such right of action.”

The fallacy of this holding is that the main cause of action is for rental due the day before the filing of the

complaint and well within the six years as provided in Title 28, Sec. 2401(a), U. S. C. The reformation being incidental to the main cause of action does not lapse until the main cause of action is barred. Also, if the action for reformation stood by itself it would not start the statute to run until the discovery of the mistake which is alleged in the complaint to be [Tr. 5] June 14, 1948. A dispute as to the meaning of the words "unlimited Emergency as proclaimed by the Presidential proclamation" could not have arisen until after the unconditional surrender of the Axis belligerents on August 14, 1945. All rentals accrued between this date and the filing of the complaint. It will be noted that the defendant has paid no rent since the termination of the hostilities.

The reformation asked in the first cause of action does not ask that the language of the lease be changed but merely asked that the dispute as to the meaning of the termination of the lease be interpreted by the court below. The meaning of the words is the same whether the lease is reformed or not. This plaintiff is still entitled to his land back and the reasonable compensation for the use and occupation of the land in question. The ruling of the court below amounts to a confiscation of the property of the plaintiff, as the defendant is still in possession with no obligation to pay for the use thereof.

It is the contention of the Government that the emergency referred to in the proclamation must be terminated by an Act of Congress. The plaintiff contends the emergency defined in the proclamation is a question of fact, and the proclamation must be looked to for a definition of the "unlimited emergency."

“PROCLAMATION 2487.

Proclaiming That an Unlimited National Emergency Confronts This Country, Which Requires That Its Military, Naval, Air and Civilian Defenses Be Put on the Basis of Readiness to Repel Any and All Acts or Threats of Aggression Directed Toward Any Part of the Western Hemisphere.

WHEREAS on September 8, 1939 because of the outbreak of war in Europe a proclamation was issued declaring a limited national emergency and directing measures ‘for the purpose of strengthening our national defense within the limits of peacetime authorizations’,

WHEREAS a succession of events makes plain that the objectives of the Axis belligerents in such war are not confined to those avowed at its commencement, but include overthrow throughout the world of existing democratic order, and a worldwide domination of peoples and economies through the destruction of all resistance on land and sea and in the air, AND

WHEREAS indifference on the part of the United States to the increasing menace would be perilous, and common prudence requires that for the security of this nation and of this hemisphere we should pass from peacetime authorizations of military strength to such a basis as will enable us to cope instantly and decisively with any attempt at hostile encirclement of this hemisphere, or the establishment of any base for aggression against it, as well as to repel the threat of predatory incursion by foreign agents into our territory and society.

NOW, THEREFORE, I, FRANKLIN D. ROOSEVELT, President of the United States of America, do proclaim that an unlimited national emergency confronts

this country, which requires that its military, naval, air and civilian defenses be put on the basis of readiness to repel any and all acts or threats of aggression directed toward any part of the Western Hemisphere.

I call upon all the loyal citizens engaged in production for defense to give precedence to the needs of the nation to the end that a system of government that makes private enterprise possible may survive.

I call upon all our loyal workmen as well as employers to merge their lesser differences in the larger effect to insure the survival of the only kind of government which recognizes the rights of labor or of capital.

I call upon loyal state and local leaders and officials to cooperate with the civilian defense agencies of the United States to assure our internal security against foreign directed subversion and to put every community in order for maximum productive effort and minimum of waste and unnecessary frictions.

I call upon all loyal citizens to place the nation's needs first in mind and in action to the end that we may mobilize and have ready for instant defensive use all of the physical powers, all of the moral strength and all of the material resources of this nation.

IN WITNESS WHEREOF I have hereunto set my hand and caused the seal of the United States of America to be affixed.

DONE at the City of Washington this twenty-seventh day of May, in the year [SEAL] of our Lord



nineteen hundred and forty-one, and of the Independence of the United States of America the one hundred and sixty-fifth.

FRANKLIN D. ROOSEVELT.

By the President:

CORDELL HULL

*Secretary of State."*

There we find the unlimited emergency is limited to a threat by "the Axis belligerents to the security of the United States." We therefore further contend that upon the unconditional surrender of the "Axis belligerents" the unlimited emergency was over as far as the lease of the plaintiff's property was concerned. The use of the plaintiff's property for the political purpose of concluding a peace treaty could not be contemplated under the terms of the lease. The President of the United States declared on the 3rd day of December, 1945, that: "there was a cessation of hostilities of World War II."

"PROCLAMATION 2714.

Cessation of Hostilities of World War II.

By the President of the United States of America

A PROCLAMATION.

With God's help this nation and our allies, through sacrifice and devotion, courage and perseverance, wrung final and unconditional surrender from our enemies. Thereafter, we, together with the other

United Nations, set about building a world in which justice shall replace force. With spirit, through faith, with a determination that there shall be no more wars of aggression calculated to enslave the peoples of the world and destroy their civilization, and with the guidance of Almighty Providence great gains have been made in translating military victory into permanent peace. Although a state of war still exists, it is at this time possible to declare, and I find it to be in the public interest to declare, that hostilities have terminated.

NOW, THEREFORE, I, HARRY S. TRUMAN, President of the United States of America, do hereby proclaim the cessation of hostilities of World War II, effective twelve o'clock noon, December 31, 1946.

IN WITNESS WHEREOF, I have hereunto set my hand and caused the seal of the United States of America to be affixed.

DONE at the City of Washington this 31st day of December in the year of our Lord nineteen hundred and [SEAL] forty-six, and of the Independence of the United States of America the one hundred and seventy-first.

HARRY S. TRUMAN.

By the President:

JAMES F. BYRNES,  
*The Secretary of State.*"

[F. R. Doc. 46-22110; Filed, Dec. 31, 1946; 1:19 p. m.]

## POINT I.

### When Reformation Is Incidental to the Main Cause of Action, the Statute of Limitations Does Not Run Until the Main Cause of Action Is Barred.

The treatment of this subject in Cal. Juris, is so clear and well treated that we will set it forth in full with the appropriate California decisions on the point:

“LIMITATIONS: Where reformation is not incidental to the main relief sought, but is an essential prerequisite to the asking of any relief, subsection 4 of section 338, Code of Civil Procedure applies, and the action must be brought within three years of the discovery, by the aggrieved party, of the facts constituting the fraud or mistake. This rule applies as well where the reformation is sought by the defendant. *But it does not apply where reformation is sought as an incident to other relief.* In such case the right to reformation is not barred as long as an action for such relief might be brought.” (22 Cal. Jur., page 723, par. 11.)

Also see, *Hutchinson v. Ainsworthy*, 73 Cal. 455:

“The facts upon which plaintiff’s right to sue are based, and upon which defendant’s duty has arisen, coupled with the facts which constitute the latter’s wrong, make up the cause of action. If these facts taken together give a unity of right, they constitute but one cause of action. In equity, the relief or the enforcement of a single right may be varied, and the facts essential to such relief may be set out without objection as auxilliary to the right to be enforced.”

In the case at bar, the object of the action is to collect a single debt, and to enforce a single lien to redress a single wrong. To accomplish this object, dual relief is sought, but this circumstance, as frequently sought, does not constitute two causes of action. Pomeroy, at section 459 of his work on remedies, in discussing the question uses the following language:

“Actions brought to reform instruments in writing  
\* \* \* and the like, and to enforce the same as reformed by judgments for the recovery of money due on the contracts, or for the foreclosure of mortgages, or for the recovery of the possession of land conveyed by deed, fall within the same general principle. One cause of action only is stated in such cases, however various may be the relief demanded and granted.”  
(*Meyer v. Van Collem*, 7 Abb. Pr. 222; *McClurg v. Phillips*, 49 Mo. 315.)

Also see, *South Tule, etc. Ditch Co. v. King*, 144 Cal. 455:

“It is urged by the plaintiff that defendant’s second amended answer should not have been allowed because the relief therein asked is on the ground of mistake, and is barred by the provision of subsection 338, Code of Civil Procedure (Cal.).”

The section provides that “an action for relief on the ground of fraud or mistake” is barred within three years. Defendants knew of the mistake more than three years before the action was commenced.

This is not an action for relief on the ground or mistake, and therefore has no application. It is an action in effect to determine the title to one-half cubic foot of



water claimed by the plaintiff. The defendants claim that they have at all times been in possession of the one-half foot, and that they never conveyed it, because the mistake in the deed. In other words, the question as to the mistake is made by the way of defense to an affirmative claim made by the plaintiff, *and is only incidental to the main question.*

See *Gardner v. Guarantee Co.*, 137 Cal. 75:

“Hence, while the contract remains in force, and not barred by the statute of limitations, there can be no bar to the real intention of the parties or to the reformation of the contract.”

Also see:

*Carman v. Athern*, 77 Cal. App. 2d 595, to same effect.

#### **The Statute Does Not Commence to Run Until the Discovery of the Mistake.**

It is too elemental to take much time on this point of the California Statute, Code of Civil Procedure, Section 338, and the cases cited heretofore establish this point. However, in the instant case the plaintiff pleads discovery as of June 14, 1948 [Tr. 5]. But a reading of the complaint as a whole discloses that a dispute over the interpretation of the clause terminating the lease could not have occurred until actual “cessation of hostilities” and possibly until the proclamation of the President of the United States on December 3, 1945.

## POINT II.

**The Reformation Here Merely Asks the Court to Determine What the Instrument Was Intended to Mean.**

The code of the State of California lays down the rule for the inquiry into the meaning of a written contract.

Civil Code, Section 3401:

“Scope of Inquiry.—In revising a written instrument, the court may inquire what the instrument was intended to mean, and what were intended to be its legal consequences, and is not confined to the inquiry what the language was intended to be.”

Also see:

*F. P. Cutting v. Peterson*, 164 Cal. 44.

## POINT III.

**The Court Below Erred in Not Holding the Contract Lease Terminated on the “Cessation of Hostilities.”**

There is but one question to be decided by the court in the instant case, and that is, What is the meaning of the phrase “Six months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27, 1941 (Proclamation 2487). The court below held in its memorandum opinion that the laws of the State of California must be followed in the construction and interpretation of the lease contract. We accept this view. In the first place we are dealing here with a proclamation. What is the legal effect of a Presidential Proclamation? “In English law the instrument is thus defined; Proclamation (Proclomatio) is a notice

publicly given of anything whereof the King thinks fit to advise his subjects." *Lapyre v. U. S.*, 84 U. S. 191. The proclamation by the President is his official, public announcement of an order. No particular form is necessary. It is sufficient if it has such publicity as accomplishes the end to be attained.

*Wood v. Beach*, 156 U. S. 548.

#### POINT IV.

#### **The Words of a Contract Are to Be Construed and Understood in Their Ordinary and Popular Sense.**

Even if the word "End of War" was used, the popular conception would be the end of "actual hostilities."

Civil Code, Section 1644:

"Ordinary Meaning of Words.—The words of a contract are to be understood in their ordinary and popular sense, rather than to their strict legal meaning; \* \* \*"

And the intent of the terms of a contract should never be extended.

Civil Code, Section 1648:

"Intent Never to Be Extended.—However broad may be the terms of a contract, it extends only to those things concerning which it appears that the parties intended to contract."

This court has laid down the rules for the construction of a contract of this kind in, *Samuels v. United Seamen's Service*, 165 F. 2d 409.

War in its material sense must be distinguished from war in its legal sense. *U. S. v. Cain*, 72 Fed. Supp. 897.

War may come to end by the simple cessation of hostilities.

*The Three Friends*, 166 U. S. 1.

*Corpus Juris* discloses that the following wars ended merely by a cessation of hostilities. Sweden-Poland, 1716; France-Spain, 1720; Texas-Mexico, 1836 and the Spanish wars with American colonies.

Even the use of the words "end of war" to the layman and the soldier, mean the "capitulation by the enemy."

To the layman and to the soldier, the words "engaged in war" convey the thought of actual warfare, capitulation of the enemy forces. The aftermath of actual warfare necessitates political and legal cognizance of a "state of war," but that is something apart from the common understanding of the time the country ceases to be "engaged in war."

*Stinson v. New York Life*, 167 F. 2d 233.

The President may issue proclamations when he thinks it proper to give notice or information to the public.

*Muir v. Louisville & N. R. R. Co.*, 247 Fed. 888.

They have no effect as law in the absence of constitutional or congressional authority. (*Idem.*)

See text, *The President Office and Powers*, by Corwin, page 363 of notes.

It is clear that the "unlimited emergency" as defined by the Presidential proclamation is a question of fact. It



did not create an emergency. It just proclaimed to the people that one existed. It is clear that the proclamation of May 27, 1941, advised the people that the emergency consisted of a threat to the security of the United States by the "axis belligerents."

We quote from the second paragraph thereof:

"Whereas a succession of events makes plain that the objectives of the *axis belligerents* in such war are not confined to those avowed at its commencement, but includes overthrow throughout the world of existing democratic order, and a world wide domination of the peoples and economics through the destruction of all resistance on land and sea and in the air."

At the time the lease agreement was signed we were actually at war with the "axis belligerents," which consisted of Germany, Austria, Italy and the Imperial government of Japan. Upon the unconditional surrender of the axis belligerents the emergency as defined by the Presidential proclamation was at an end. This was duly signified by the Presidential Proclamation of December 3, 1945, wherein the President declared "that there was a cessation of actual hostilities of World War II." To the same effect see:

*Ex parte Blaney*, 184 P. 2d 901 (Cal.);

*Kaiser v. Hopkins*, 6 Cal. 2d 537, 58 P. 2d 1278;

*Hoover v. San Defer*, 25 Wash. 2d 791, 171 P. 2d 1009;

*State ex rel v. Listman*, 157 Wash. 229, 288 Pac. 913;

*U. S. v. Anderson*, 76 U. S. 56.

Wherefore the appellant respectfully submits that the order dismissing this cause be reversed and the defendant be made to file his answer in due course.

Respectfully submitted, \*

ERWIN P. WERNER,

*Appellant, In Pro. Per.*

No. 12612

---

In the United States Court of Appeals  
for the Ninth Circuit

---

ERWIN P. WERNER, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

---

UPON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR  
THE SOUTHERN DISTRICT OF CALIFORNIA, CENTRAL DIVISION

---

BRIEF FOR THE UNITED STATES, APPELLEE

---

A. DEVITT VANECH,

*Assistant Attorney General.*

ERNEST A. TOLIN,

*United States Attorney,*

*Los Angeles, California.*

IRL D. BRETT,

*Special Assistant to the Attorney General,*

*Los Angeles, California.*

ROGER P. MARQUIS

HAROLD S. HARRISON,

*Attorneys, Department of Justice,*

*Washington, D. C.*

---

FILED

OCT 21 1950

PAUL P. O'BRIEN.





# INDEX

---

	Page
Opinion below.....	1
Jurisdiction.....	1
Statutes involved.....	2
Questions presented.....	2
Statement.....	3
Argument:	
I. The court lacked jurisdiction of this action because more than six years had elapsed since accrual of the alleged cause....	5
II. The lease cannot be construed as prohibiting renewals which extended six months beyond the cessation of hostilities.....	9
Conclusion.....	12
Appendix.....	13

## CITATIONS

Cases:	
<i>Goodfellow v. Barritt</i> , 130 C. A. 548, 20 P. 2d 740.....	7
<i>Leahey v. Department of Water &amp; Power</i> , 76 C. A. 2d 281, 173 P. 2d 69.....	6
<i>Norris v. Haggin</i> , 28 Fed. 275, affirmed 136 U. S. 386.....	6
<i>Phelps v. Grady</i> , 168 Cal. 73, 141 Pac. 926.....	6
<i>Samuels v. United Seamen's Service</i> , 165 F. 2d 409.....	11
<i>Scafidi v. Western Loan &amp; Bldg. Co.</i> , 72 C. A. 2d 550, 165 P. 2d 260.....	6
<i>Teall v. Slaven</i> , 40 Fed. 774.....	6
<i>Wood v. Carpenter</i> , 101 U. S. 135.....	6
<i>Woods v. Miller Co.</i> , 333 U. S. 138.....	10
Statutes:	
Act of July 25, 1947, 61 Stat. 449.....	9
28 U.S.C. sec. 2401 (a).....	5
Cal. Civ. Code:	
sec. 2267.....	17
sec. 2300.....	17
sec. 2332.....	18
Cal. Code Civ. Proc. secs. 335, 338.....	9
Miscellaneous:	
Presidential Proclamation 2714 of December 31, 1946, 12 F. R. 1, 61 Stat. 1048, 50 App., U. S. C., sec. 601, p. 5728.....	10, 15
Presidential Proclamation 2487 of May 21, 1941, 6 F. R. 2617, 55 Stat. 1647, 50 App., U. S. C., p. 5636.....	13
Statement by the President of the United States on December 31, 1946, CCH—War Law Service (2d ed.) paragraph 2516, p. 2223.....	10, 16



**In the United States Court of Appeals  
for the Ninth Circuit**

---

No. 12612

ERWIN P. WERNER, APPELLANT

*v.*

UNITED STATES OF AMERICA, APPELLEE

---

*UPON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR  
THE SOUTHERN DISTRICT OF CALIFORNIA, CENTRAL DIVISION*

---

**BRIEF FOR THE UNITED STATES, APPELLEE**

---

**OPINION BELOW**

A memorandum opinion of the district court filed May 26, 1950 (R. 24-30), has not been reported.

**JURISDICTION**

This is an appeal from an order entered by the district court on June 9, 1950 (R. 31) dismissing appellant's complaint for want of jurisdiction over the United States. The jurisdiction of the district court was sought to be invoked under 28 U. S. C. sec. 1346 (a). On June 12, 1950, appellant filed his notice of appeal (R. 32). The jurisdiction of this Court is invoked under 28 U. S. C. sec. 1291.

### STATUTES INVOLVED

1. Title 28, U. S. C., sec. 2401 (a) provides as follows:

(a) Every civil action commenced against the United States shall be barred unless the complaint is filed within six years after the right of action first accrues. The action of any person under legal disability or beyond the seas at the time the claim accrues may be commenced within three years after the disability ceases.

2. Presidential Proclamation 2487 of May 27, 1941, 6 F. R. 2617, 55 Stat. 1647, 50 App., U. S. C., Note prec. sec. 1, p. 5636; Presidential Proclamation 2714 of December 31, 1946, 12 F. R. 1, 61 Stat. 1048, 50 App., U. S. C., sec. 601, p. 5728; Statement by the President of the United States on the issuing of Proclamation 2714 of December 31, 1946, CCH, War Law Service (2d ed.) paragraph 2516, p. 2223; and California Civil Code, sections 2267, 2300 and 2332, are set forth in the appendix, pp. 13-18, *infra*.

### QUESTIONS PRESENTED

1. Whether the beneficiary of a trust may sue to reform a lease executed by trustees because of alleged mutual mistake more than six years after execution of the lease.

2. Whether a proclamation terminating hostilities prevented further renewal of a lease which provided that no renewal could extend "beyond six (6) months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27th, 1941".



## STATEMENT

This action involves a 40 acre tract of land which is part of the March Air Force Base Camp Haan Magazine Area located in Riverside County, California. A lease of the premises to the United States for military purposes was executed on February 1, 1943, by Mark L. Herron and Barbara W. Herron, who executed the lease as fee owners, that is, "for themselves, their heirs, executors, administrators, successors, and assigns" (R. 7-11). The lease provided for a rental of \$25.00 per year and for renewal from year to year at that rental at the option of the Government "provided that no renewal thereof will extend the period of occupancy of the premises beyond six (6) months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27th, 1941 (Proclamation 2487)" (R. 8-9). A supplemental agreement to dispense with notice of renewal was entered into between the same parties on May 31, 1943 (R. 15-17). This supplemental agreement was also executed by the Herrons "for themselves, their heirs, executors, administrators, successors, and assigns" and it also provided "that this lease shall in no event extend beyond six months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27, 1941 (Proclamation)"<sup>1</sup> (R. 16).

---

<sup>1</sup> Though recitation of the proclamation number appears to have been inadvertently omitted at this point in the supplemental agreement, the proclamation is designated by number as well as date earlier in the supplemental agreement (R. 15).

On November 8, 1949, Erwin P. Werner, the appellant herein, filed a complaint alleging that at all times material he "has been, and now is, the legal owner in fee" of the premises involved and that Mark L. Heron and Barbara W. Herron held the premises in trust (R. 2-3). The complaint alleged that "by and through a mutual mistake of Plaintiff and Defendant, \* \* \* said lease did not and does not now truly state or express the intention of the said parties" and sought reformation of the lease to have the language "that this lease shall in no event extend beyond six months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27, 1941 (Proclamation 2487)" reformed to say "six months from the date of the cessation of actual hostilities with the said Axis nations, then at war, or the surrender of said Axis nations" (R. 4). The complaint also alleged that appellant did not discover the alleged mutual mistake until June 14, 1948 (R. 5). As a second cause of action the complaint alleged that the lease in question was terminated on August 14, 1945, "by reason of the said cessation of hostilities on the part of the said Axis nations"; that the fair market value of the land is \$20,000.00 and that the use of the property was worth \$2,500.00 per year. Accordingly, the complaint also contained a prayer for the reasonable value of the use and occupation of the property since August 14, 1945 (R. 6).

The United States filed a special appearance and a motion to dismiss the complaint on the grounds that the court did not have jurisdiction over the

United States and that the complaint fails to state a claim upon which relief can be granted (R. 18-20). The trial court found that appellant's right of action first accrued on February 1, 1943, the date of the execution of the lease between Mark L. Herron and Barbara W. Herron and the United States; that this action was commenced on November 8, 1949, which was more than six years following the date of accrual of such right of action, that appellant's claim is, therefore, barred by the provisions of 28 U. S. C., sec. 2401 (a) and hence the court did not have jurisdiction over the person of the defendant, United States of America. Accordingly, on June 9, 1950, an order was entered dismissing the complaint for want of jurisdiction over the United States (R. 31). On June 12, 1950, appellant filed his notice of appeal (R. 32).

#### ARGUMENT

#### I

**The court lacked jurisdiction of this action because more than six years had elapsed since accrual of the alleged cause**

The present action was filed November 8, 1949. More than six years had expired since the lease contract was executed on February 1, 1943. It is apparent that the six year limitation upon institution of such suits against the United States bars an action to reform that instrument unless facts are alleged which tolled the running of the statute. No such facts are alleged. The allegation of the complaint in this respect is simply (R. 5) :

That until the reconveyance to Plaintiff of said real property, as aforesaid, the terms and



conditions of said lease agreement and mutual mistake were unknown to the Plaintiff herein, until June 14, 1948, when a copy of said lease was delivered to Plaintiff by said trustee. \* \* \*

But the mere fact of ignorance prior to certain dates will not operate to toll the statute of limitations absent a showing that with diligence the fact would not have been discovered. *Wood v. Carpenter*, 101 U. S. 135, 140-141 (1879); *Norris v. Haggin*, 28 Fed. 275, 280-281 (C. C. Cal. 1886), affirmed 136 U. S. 386 (1890); *Teall v. Slaven*, 40 Fed. 774 (C. C. N. D. Cal. 1889); *Scafidi v. Western Loan & Bldg. Co.*, 72 C. A. 2d 550, 566, 165 P. 2d 260, 269-270 (1946); *Leahey v. Department of Water & Power*, 76 C. A. 2d 281, 287, 173 P. 2d 69, 73 (1946); *Phelps v. Grady*, 168 Cal. 73, 77-78, 141 Pac. 926, 927-928 (1914).

In the *Scafidi* case, *supra*, it is said:

Our courts have repeatedly affirmed that mere ignorance of the facts constituting a cause of action on the part of a plaintiff does not prevent the running of the statute of limitations [citing cases]; and that "mere ignorance of the facts, \* \* \* without some valid reason for ignorance, was of no consequence" (*Dennis v. Bint*, 122 Cal. 39, 44 [54 P. 378, 68 Am. S. Rep. 17] [citing authority]). Such, only, is the position in which plaintiffs' complaint places them in this case. The last cited cases are, in effect, a recognition of the prevailing rule that a failure to discover a cause of action does not, as in the case of its fraudulent concealment, suspend the running of the statute of limitations.



Thus in the case of *Goodfellow v. Barritt*, 130 C. A. 548, 20 P. 2d 740 (1933), which was cited by the court below (R. 30), the action was barred by limitations where the complaint filed seven years after the execution of the deed failed to show excuse for failure to discover the mistake within a reasonable time.

Here, the alleged mistake is in the permissible period for renewal of the lease term. As implied from appellant's allegation quoted above, such alleged mistake would become apparent merely from reading the instrument. The claim that appellant did not read the lease until the property was reconveyed to him in 1948 is no excuse because, as the trial court held (R. 29-30):

In the case at bar the trustees who made the lease were plaintiff's agents [Cal. Civ. Code Secs. 2267, 2300], and their knowledge of the alleged mutual mistake upon which plaintiff's right of action is founded must be imputed to him. [Cal. Civ. Code Sec. 2332.] <sup>2</sup>

Moreover, the fact that the United States remained in possession after August 14, 1945, the time when appellant claims the lease was to terminate (R. 6) would itself put a reasonable person upon inquiry as to the authority under which the United States remained in possession.

Appellant does not directly challenge the holding of the court below that the trustees who made the

---

<sup>2</sup> It should be noted that there is no allegation that the parties to the instrument, i. e., the trustees and the United States were mistaken but only that the plaintiff and the United States were mistaken (R. 4).

lease were his agents and that their knowledge of the alleged mutual mistake upon which his right is founded must be imputed to him. He seeks, however, to avoid the result below by arguing that this is an action for rent and that relief by way of reformation of the contract is only incidental thereto. No such cause of action for rent is alleged. This is obvious from the fact that rather than seeking recovery of a contracted amount for rent, appellant seeks reasonable value of the use and occupation (R. 6). Indeed, while appellant's brief in this Court states (p. 4): "It will be noted that the defendant has paid no rent since the termination of the hostilities,"<sup>3</sup> the complaint will be searched in vain for any such allegation. Appellant's whole theory as stated in the complaint is that the lease terminated on August 14, 1945, and he seeks to recover reasonable value of the use and occupation since that date (R. 6). There is, therefore, no basis for the argument that reformation is sought merely as relief incidental to enforcement of a contractual obligation.

---

<sup>3</sup> Because appellant has gone outside of the record in stating that "the defendant has paid no rent since the termination of hostilities" (Br. 4), the Government feels obligated to say that while there is in fact rental due under the terms of the lease, it is because the appellant and his alleged trustees have refused to execute vouchers and other papers necessary for the payment of the rent reserved despite numerous attempts on the part of Government agents to get them to do so. This in no way alters the situation in the instant case. The fact remains that appellant's complaint does not allege a cause of action for rent in accordance with the terms of the lease.

The case was therefore properly dismissed because the alleged cause of action had accrued more than six years prior to filing of the suit.<sup>4</sup>

## II

**The lease cannot be construed as prohibiting renewals which extended six months beyond the cessation of hostilities**

The original lease and the supplemental agreement are unambiguous. They provide that no renewal "will extend the period of occupancy of the premises beyond six (6) months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27, 1941 (Proclamation 2487)" (R. 9, 15, 16). This unlimited emergency has not been terminated except as to certain specific statutory provisions listed in the Act of July 25, 1947, 61 Stat. 449.

Recognizing that the result he sought could not be achieved by any process of construction of the lease, appellant's complaint sought to substitute the language "six months from the date of the cessation of actual hostilities with the said Axis nations then at war, or the surrender of said Axis nations" (R. 4) for the lease provision above-quoted. Apparently now, however, he seeks to reach such result by a process of construction.

---

<sup>4</sup> Since this is so, it is unnecessary to consider whether the alleged mistake should have been discovered by November 8, 1946, and would therefore be barred by the three year California limitation upon such suits, Cal. Code Civ. Proc. Secs. 335, 338.



Insofar as appellant relies on Presidential Proclamation 2714 of December 31, 1946, in his contention that such unlimited emergency has been terminated (R. 4-5, Br. 15),<sup>5</sup> he is going contrary to the language of the proclamation and the express declaration of the President of the United States who issued the proclamation. The proclamation itself states that "a state of war still exists" (*infra*, p. 15), and in his statement accompanying his proclamation of December 31, 1946, the President of the United States said, *inter alia* (CCH—War Law Service (2d ed.) paragraph 2516, p. 2223 [full text of statement printed in appendix, *infra*, pp. 16-17]):

It should be noted that the proclamation does not terminate the states of emergency declared by President Roosevelt on September 8, 1939, and May 27, 1941. Nor does today's action have the effect of terminating the state of war itself. It terminates merely the period of hostilities. With respect to the termination of the national emergency and the state of war I shall make recommendations to the Congress in the near future.<sup>6</sup>

---

<sup>5</sup> Though on pages 11 and 15 of his brief appellant refers to a Presidential Proclamation of December 3, 1945, it is believed apparent that he is referring to Presidential Proclamation 2714 issued December 31, 1946, which appellant sets out on pages 7-8 of his brief and which is referred to in his complaint (R. 4-5).

<sup>6</sup> Also on July 25, 1947, the President of the United States declared that "The emergencies declared by the President on September 8, 1939, and May 27, 1941, and the state of war continue to exist, \* \* \*." See *Woods v. Miller Co.*, 333 U. S. 138, 140, footnote 3 (1948).



Similarly, the decision of this Court in the case of *Samuels v. United Seamen's Service*, 165 F. 2d 409, cited by appellant (Br. 13), reaffirms our position here. The lease in the *Samuels* case provided that its terms should "extend for a period of six (6) months from and after the cessation of hostilities in the present war with Japan" (165 F. 2d 409, 410). This Court held that hostilities, in fact, had ceased, saying (p. 411):

It is true that certain war-time federal statutes were to be terminated "upon the cessation of hostilities, as proclaimed by the President." Such statutes were obviously operative until a formal Presidential proclamation. But the lease did not provide that the term should end concurrently with the termination of such statutes or upon any such Presidential proclamation. It is silent as to any such matters and we cannot infer that the parties, in executing the lease, deliberately intended to make formal Presidential or Congressional action a yardstick of time wherewith to measure the lease term. It would have been a very simple matter to so indicate had the parties desired to make this sort of official action the decisive test.

In the instant case the lease expressly adopted as a yardstick the termination by Congress or the President of the unlimited emergency declared in 1941. Since that event has not yet happened, we submit that the lease cannot be cut short by any process of construction.

## CONCLUSION

For the foregoing reasons it is respectfully submitted that the judgment of the district court should be affirmed.

A. DEVITT VANECH,  
*Assistant Attorney General.*

ERNEST A. TOLIN,  
*United States Attorney,  
Los Angeles, California.*

IRL D. BRETT,  
*Special Assistant to the Attorney General,  
Los Angeles, California.*

ROGER P. MARQUIS,  
HAROLD S. HARRISON,  
*Attorneys, Department of Justice,  
Washington, D. C.*

OCTOBER 1950.

## APPENDIX

Presidential Proclamation 2487 of May 21, 1941, 6 F. R. 2617, 55 Stat. 1647, 50 App. U. S. C. Note prec. sec. 1, p. 5636, is as follows:

PROCLAIMING THAT AN UNLIMITED NATIONAL EMERGENCY CONFRONTS THIS COUNTRY, WHICH REQUIRES THAT ITS MILITARY, NAVAL, AIR AND CIVILIAN DEFENSES BE PUT ON THE BASIS OF READINESS TO REPEL ANY AND ALL ACTS OR THREATS OF AGGRESSION DIRECTED TOWARD ANY PART OF THE WESTERN HEMISPHERE

BY THE PRESIDENT OF THE UNITED STATES  
OF AMERICA

### A PROCLAMATION

WHEREAS on September 8, 1939 because of the outbreak of war in Europe a proclamation was issued declaring a limited national emergency and directing measures "for the purpose of strengthening our national defense within the limits of peacetime authorizations",

WHEREAS a succession of events makes plain that the objectives of the Axis belligerents in such war are not confined to those avowed at its commencement, but include overthrow throughout the world of existing democratic order, and a worldwide domination of peoples and economies through the destruction of all resistance on land and sea and in the air, AND

WHEREAS indifference on the part of the United States to the increasing menace would be perilous, and common prudence requires that for the security of this nation and of this hemisphere we should pass from peacetime

authorizations of military strength to such a basis as will enable us to cope instantly and decisively with any attempt at hostile encirclement of this hemisphere, or the establishment of any base for aggression against it, as well as to repel the threat of predatory incursion by foreign agents into our territory and society,

NOW, THEREFORE, I, FRANKLIN D. ROOSEVELT, President of the United States of America, do proclaim that an unlimited national emergency confronts this country, which requires that its military, naval, air and civilian defenses be put on the basis of readiness to repel any and all acts or threats of aggression directed toward any part of the Western Hemisphere.

I call upon all the loyal citizens engaged in production for defense to give precedence to the needs of the nation to the end that a system of government that makes private enterprise possible may survive.

I call upon all our loyal workmen as well as employers to merge their lesser differences in the larger effort to insure the survival of the only kind of government which recognizes the rights of labor or of capital.

I call upon loyal state and local leaders and officials to cooperate with the civilian defense agencies of the United States to assure our internal security against foreign directed subversion and to put every community in order for maximum productive effort and minimum of waste and unnecessary frictions.

I call upon all loyal citizens to place the nation's needs first in mind and in action to the end that we may mobilize and have ready for instant defensive use all of the physical powers, all of the moral strength and all of the material resources of this nation.



IN WITNESS WHEREOF I have hereunto set my hand and caused the seal of the United States of America to be affixed.

DONE at the City of Washington this twenty-seventh day of May, in the year of our Lord nineteen hundred and forty-one, and  
 [SEAL] of the Independence of the United States of America the one hundred and sixty-fifth.

FRANKLIN D. ROOSEVELT.

By the President:

CORDELL HULL,  
*Secretary of State.*

[No. 2487]

[F. R. Doc. 41-3808; Filed, May 28, 1941; 9:45 a. m.]

---

Presidential Proclamation 2714 of December 31, 1946, 12 F. R. 1, 61 Stat. 1048, 50 App. U. S. C. § 601, p. 5728, is as follows:

CESSATION OF HOSTILITIES OF WORLD WAR II  
 BY THE PRESIDENT OF THE UNITED STATES OF  
 AMERICA

A PROCLAMATION

With God's help this nation and our allies, through sacrifice and devotion, courage and perseverance, wrung final and unconditional surrender from our enemies. Thereafter, we, together with the other United Nations, set about building a world in which justice shall replace force. With spirit, through faith, with a determination that there shall be no more wars of aggression calculated to enslave the peoples of the world and destroy their civilization, and with the guidance of Almighty Providence great gains have been made in translating military victory into permanent peace. Although

a state of war still exists, it is at this time possible to declare, and I find it to be in the public interest to declare, that hostilities have terminated.

NOW, THEREFORE, I, HARRY S. TRUMAN, President of the United States of America, do hereby proclaim the cessation of hostilities of World War II effective twelve o'clock noon, December 31, 1946.

IN WITNESS WHEREOF, I have hereunto set my hand and cause the seal of the United States of America to be affixed.

DONE at the City of Washington this 31st day of December in the year of our Lord nineteen hundred and forty  
[SEAL] six, and of the Independence of the United States of America the one hundred and seventy-first.

HARRY S. TRUMAN.

By the President:

JAMES F. BYRNES,  
*The Secretary of State.*

[F. R. Doc. 46-22110; Filed, Dec. 31, 1946; 1:19 p. m.]

---

A statement by the President of the United States made on December 31, 1946, CCH-War Law Service (2d ed.) paragraph 2516, p. 2223, is as follows:

#### STATEMENT BY THE PRESIDENT

I have today issued a proclamation terminating the period of hostilities of World War II, as of 12 o'clock noon today, December 31, 1946.

Under the law, a number of war and emergency statutes cease to be effective upon the issuance of this proclamation. It is my belief that the time has come when such a declaration

can properly be made, and that it is in the public interest to make it. Most of the powers affected by the proclamation need no longer be exercised by the executive branch of the Government. This is entirely in keeping with the policies which I have consistently followed, in an effort to bring our economy and our government back to a peacetime basis as quickly as possible.

The proclamation terminates government powers under some 20 statutes immediately upon its issuance. It terminates government powers under some 33 others at a later date, generally at the end of 6 months from the date of the proclamation. This follows as a result of provisions made by the Congress when the legislation was originally passed. In a few instances the statutes affected by the Proclamation give the government certain powers which in my opinion are desirable in peacetime, or for the remainder of the period of reconversion. In these instances, recommendations will be made to the Congress for additional legislation.

It should be noted that the proclamation does not terminate the states of emergency declared by President Roosevelt on September 8, 1939, and May 27, 1941. Nor does today's action have the effect of terminating the state of war itself. It terminates merely the period of hostilities. With respect to the termination of the national emergency and the state of war I shall make recommendations to the Congress in the near future.

December 31, 1946

California Civil Code § 2267 provides as follows:

SEC. 2267. Trustee's powers as agent. A trustee is a general agent for the trust property. His authority is such as is conferred upon him by the declaration of trust and by this chapter, and none other. His acts, within the scope of

his authority, bind the trust property to the same extent as the acts of an agent bind his principal.

California Civil Code § 2300 provides as follows:

SEC. 2300. Ostensible agency. An agency is ostensible when the principal intentionally, or by want of ordinary care, causes a third person to believe another to be his agent who is not really employed by him.

California Civil Code § 2332 provides as follows:

SEC. 2332. Notice to agent, when notice to principal. As against a principal, both principal and agent are deemed to have notice of whatever either has notice of, and ought, in good faith and the exercise of ordinary care and diligence, to communicate to the other.



No. 12612

---

In the  
United States  
Court of Appeals  
For the Ninth Circuit

---

ERWIN P. WERNER,

*Appellant,*

vs.

UNITED STATES OF AMERICA,

*Appellee.*

---

Appellant's Closing Brief

---

ERWIN P. WERNER,  
5611 Carlton Way, Los Angeles 28,  
*Appellant, In Pro. Per.*

---

FILED

OCT 28 1950



## TOPICAL INDEX

	Page
War Power Is Not Involved.....	4

---

## TABLE OF CASES AND AUTHORITIES CITED

Wood v. Miller, 333 U. S. 141.....	3, 4, 5
------------------------------------	---------





In the  
United States  
Court of Appeals  
For the Ninth Circuit

---

ERWIN P. WERNER,

*Appellant,*

vs.

UNITED STATES OF AMERICA,

*Appellee.*

---

Appellant's Closing Brief

---

This is an action for money, or compensation, for use and occupation of land. An original lease is referred to in the complaint to show:

- (a) How the government first came into possession of the land here in question.
- (b) To show title in the plaintiff.
- (c) To establish the date from which the plaintiff in this action is entitled to reasonable compensation for the use of his land.

The plaintiff asks no right which grows out of the original lease.

Reformation in the second cause of action is asked in order to interpret the following language which terminated the lease on the land in question, to wit:

“and provided further that this lease shall in no event extend beyond six months from the date of the termination of the unlimited emergency, as declared by the President of the United States on May 27th, 1941.”

Whether reformation is the proper remedy or not, the above language must be interpreted by the court in order to determine when compensation for the use of the land in question started after termination of the unlimited emergency.

The court below erroneously held that both causes of action are barred because the original lease was executed on the 31st day of May 1943.

The date of the execution of the lease has nothing to do with either cause of action other than to identify the lease as of the date mentioned.

Is it possible that the second cause for compensation is barred because the original lease was executed in 1943? All the rentals or compensation claimed accrued immediately before the filing of the complaint.

In our opening brief we contended that the emergency referred to in the proclamation of 1941, is a pure question of fact and could not be terminated by a subsequent proclamation or even an Act of Congress unless

both parties agreed thereto in the original lease of May 31st, 1943.

But there is no such agreement or provision in the lease which is referred to in the plaintiff's complaint.

Therefore the only question is a judicial one to wit: When did the threat to the security of the United States cease by the "axis Belligerents"?

The attorney general claims in his reply brief that the threat to the security of the United States cannot cease until either the President by proclamation or Congress by appropriate legislation says so.

Again we say we did not so contract.

The defendant in support thereof cites a statement issued contemporaneously with the proclamation of December 31st, 1946 and further cited *Wood v. Miller*, 333 U. S. 141. But a careful examination will reveal that they support the plaintiff's position in this matter.

## WAR POWER IS NOT INVOLVED

This case involves the relation of two contracting parties and does not bring into play the war powers of the government. After reading Woods, *supra*, it will become clear that the court wished that the interpretation of its decision be not extended and that it went no further than granting power to Congress to deal with those matters or evils which were caused by or grew out of the war. The defendant makes the following exaggerated statement (Br. 9):

“This unlimited emergency has not been terminated except as to certain specific statutory provisions listed in the Act of July 25th, 1947.”

The plaintiff and defendant in this action agreed in writing as to the termination of their rights under the lease and the President by proclamation and Congress by legislation was impotent to alter those rights agreed upon. Their respective rights became vested. This court alone has the right and power to determine what was meant by the phrase “termination of the unlimited emergency.”

However Woods, *supra*, and the statement of December 31st, 1946, was never intended to include the private dealings of citizens in their business affairs and was meant to extend to legislation by Congress which specifically was made to come to an end by the presidential proclamation, and to those war powers



dealing with conditions brought about by the war. Justice Jackson specifically said that unless based on constitutional authority war power should not be extended to affect personal and property rights.

Justice Jackson in his concurring opinion in *Woods*, *supra*, summarizes our position so well that we make it part of our argument.

*Wood v. Miller*, 333 U. S. 138 at page 146:

“Mr. Justice Jackson concurring.

I agree with the result in this case, but the arguments that have been addressed to us lead me to utter more explicit misgivings about war powers than the court has done. The government asserts no constitutional basis for this legislation other than this vague undefined and undefinable ‘war power.’

No one will question that this power is the most dangerous one to free government in the whole catalogue of powers. It usually is invoked in haste and excitement when calm legislative consideration of constitutional limitation is difficult. It is executed in a time of patriotic fervor that makes moderation unpopular. And, worst of all, it is interpreted by judges under the same influences and passions and pressures. Always as in this case, the Government urges hasty decision to forestall some emergency or serve some purpose and pleads that paralysis will result if its claims to power are denied or their confirmation delayed.

Particularly when the war power is invoked

to do things to the liberties of the people, or to their property or economy that only indirectly affect conduct of the war and do not relate to the management of the war itself, the constitutional basis should be scrutinized with care.

I think we can hardly deny that the war power is as valid a ground for federal rent control now as it has been at any time. We still are technically in a state of war, I would not be willing to hold that war powers may be indefinitely prolonged merely by keeping legally alive a state of war that had in fact ended. I cannot accept the argument that war powers last as long as the effects and consequences of war, for if so they are permanent as the war debts. . . . ”

We therefore submit the order of the lower court be reversed and the defendant be compelled to file his answer forthwith.

Respectfully submitted,

ERWIN P. WERNER,

*In Pro. Per.*

No. 12618

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

MOLLY A. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

---

Transcript of Record

---

Petition to Review a Decision of the Tax Court  
of the United States

FILED

OCT 24 1950

PAUL P. O'BRIEN,  
CLERK





No. 12618

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

MOLLY A. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

---

Transcript of Record

---

Petition to Review a Decision of the Tax Court  
of the United States



## INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

	PAGE
Answer .....	28
Appearances .....	1
Application for Extension of Time Within Which To File Record and Docket Case on a Petition for Review From a Decision of the Tax Court of the U. S.....	309
Certificate of Clerk.....	307
Computation for Entry of Decision.....	281
Decision .....	284
Exhibits, Petitioner's:	
No. 13—Map of California.....	110
14—Statement .....	112
15—Certificate of Co-Partnership Transacting Business Under Ficti- tious Name .....	115
16—Note Dated January 2, 1943.....	118
17—Note Dated January 2, 1943.....	120
18—Income of Floyd J. Harkness and Molly A. Harkness From Com- munity Property Not Included in Capital and Assets of United Packing Co., a Co-Partnership...	124

## INDEX

## PAGE

## Exhibits, Respondent's:

M—Partnership Return ..... 161

N—Income Tax Return of Mr. Harkness  
for 1943 ..... 176

Findings of Fact and Opinion of the Tax  
Court ..... 250

Notice of Filing Petition for Review..... 304

Petition ..... 2

Exhibit A—Notice of Deficiency..... 9

B—Articles of Co-Partnership.... 14

C—Supplemental Agreement ..... 26

Petition of Molly A. Harkness, for Review by  
the U. S. Court of Appeals of a Decision by  
the Tax Court of the U. S..... 285

Praecipe for Record..... 305

Proceedings ..... 82

Opening Statement on Behalf of the Peti-  
tioners ..... 83

Opening Statement on Behalf of the Re-  
spondent ..... 101

Statement of Points on Which Appellant In-  
tends To Rely and Designation of Parts of  
the Record Necessary for Consideration  
Thereof ..... 311

Stipulation for Consolidation on Petition for  
Review ..... 316

Stipulation of Facts..... 30



INDEX	PAGE
Exhibit 1-A—Statement Showing the Pay- ment of Notes.....	37
2-B—Supplemental Agreement ...	37
3-C—Agreement .....	41
4-D—Analysis of Chris A. Soren- sen's Income .....	52
5-E—Schedule .....	53
6-F—Capital Accounts for 1943 to 1947 .....	55
7-G—Grant Deed .....	69
8-H—Supplemental Agreement ...	75
9-I —Supplemental Agreement ...	78

## Witnesses, Petitioner's:

## Colgate, Harriet Harkness

—direct .....	194
—cross .....	204

## Colgate, William Hoyt Jr.

—direct .....	210
—cross .....	222
—redirect .....	224

## Harkness, Floyd J.

—direct .....	105
—cross .....	149, 159
—redirect .....	189
—recross .....	193

## Harkness, Floyd James Jr.

—direct .....	225
—cross .....	245



## APPEARANCES

For Petitioner :

PHILIP S. EHRLICH, ESQ.,  
ALBERT A. AXELROD, ESQ.,  
LeROY H. GUNTHER, ESQ.,  
E. J. HECHT, ESQ.

For Respondent :

T. M. MATHER, ESQ.,  
R. C. WHITLEY, ESQ.

## The Tax Court of the United States

MOLLY A. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

## PETITION

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Office of Internal Revenue Agent in Charge, San Francisco Division, IRS:90-D-DMR) dated August 21, 1947, and as a basis of her proceeding, alleges as follows:

1. The petitioner is an individual with her residence at 3767 Huntington Boulevard, in the City of Fresno, State of California. The return for the period here involved was filed with the Collector for the First District of California.

2. The notice of deficiency (a copy of which is attached hereto and marked Exhibit "A") was mailed to the Petitioner on August 21, 1947.

3. The taxes in controversy are income and victory taxes for the calendar year 1943, in the amount of \$64,781.64.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The refusal of the respondent to recognize



that the petitioner and her husband, Floyd J. Harkness, and their children, Floyd James Harkness, Jr. and Harriet Harkness Colgate, were copartners transacting business under the firm name and style of United Packing Co.;

(b) The determination by the respondent that the said Floyd James Harkness, Jr. and Harriet Harkness Colgate contributed no capital to said partnership known as United Packing Co., originating with themselves;

(c) The determination by the respondent that the said Floyd James Harkness, Jr. and Harriet Harkness Colgate rendered no services to the business of the partnership known as United Packing Co.;

(d) The determination by the respondent that the said Floyd James Harkness, Jr. and Harriet Harkness Colgate did not acquire valid partnership interests in the said United Packing Co.;

(e) The re-allocation of the profits of the said partnership known as United Packing Co. by the respondent to the petitioner and her husband, Floyd J. Harkness, on a community property basis, thus increasing petitioner's taxable income by \$71,770.50.

5. The facts upon which petitioner relies as a basis of this proceeding are as follows:

(a) On December 31, 1942, petitioner, Floyd J. Harkness, Floyd James Harkness, Jr. and Harriet Harkness Colgate entered into written Articles of Copartnership, under and by virtue of the terms of which they agreed, among other things, to become copartners in the business of growing, packing, ship-

ping and distributing fresh fruits and vegetables in the State of California under the firm name and style of United Packing Co., commencing January 1, 1943, and continuing until the partners should dissolve the partnership or until the partnership should be dissolved as provided in said partnership agreement. A copy of said Articles of Copartnership is attached hereto and marked Exhibit "B" and made a part hereof.

(b) Petitioner and Floyd J. Harkness are husband and wife, and Floyd James Harkness, Jr. and Harriet Harkness Colgate are their children.

(c) The partnership capital consisted of cash and real and personal property having a value of \$138,241.61, which capital was contributed by the partners in equal amounts. The interests of the husband and wife were community property and it retained that character. There has been no attempt on the part of the husband and wife to convert the wife's or the husband's interests into separate property. The children borrowed the funds for their capital contributions from their father and gave him their respective promissory notes for such borrowed funds, which notes have been paid by the children in full with interest.

(d) The present partnership was the successor to several previous partnerships, the first of which was started in 1923, under the same name, to-wit, United Packing Co. The succeeding partnerships have engaged in similar businesses uninterrupted since the organization of the first partnership. The petitioner's husband was a partner in each of the re-

spective partnerships, and in which partnerships persons other than members of the petitioner's family were members.

(e) At the time the said partnership agreement, (Exhibit "B" attached hereto) was entered into, Harriet Harkness Colgate was married to William H. Colgate, Jr. He and Floyd James Harkness, Jr. were both in the armed forces of the United States. Floyd James Harkness, Jr. entered the United States armed forces on January 12, 1942, and was discharged therefrom on January 6, 1946. William H. Colgate, Jr. entered the United States armed forces in 1941, and was discharged therefrom in September, 1944.

Under the terms of the partnership agreement and subsequent agreement between the parties, it was contemplated and agreed that Floyd James Harkness, Jr. and William H. Colgate, Jr., the husband of Harriet Harkness Colgate, would actively engage in the business of the partnership as soon as they were able to do so. Both of them had been trained for this purpose. William H. Colgate, Jr. was to represent his wife in the partnership, the wife's interest in the partnership as well as the profits arising from the interest being community property under the community property laws of the State of California, and accordingly the said William H. Colgate, Jr. had a vested interest in both the profits and capital of the partnership.

At the time the Articles of Copartnership were entered into, it was agreed and realized that a major portion of the work of the partnership would have to



be performed by the petitioner's husband, Floyd J. Harkness, until Floyd James Harkness, Jr. and William H. Colgate, Jr. were discharged from the armed forces and were able to actively take an interest in the partnership, and by reason of such fact there was a provision inserted in the Articles of Copartnership (Exhibit "B" attached hereto) to the effect that petitioner's husband was to be the general manager of the partnership and was to devote such portion of his time towards the business of the partnership as he should deem necessary and proper for the business of the partnership; that he was to receive for his services a certain percentage of the net profits of the business to be agreed upon between the partners from time to time, and that the remaining income of the partnership should be divided equally between all the partners; that on January 4, 1943, a supplemental agreement was entered into between the partners, fixing this compensation as 75% of the net income from the said partnership, United Packing Co., up to the amount of \$100,000 which agreement stated that this compensation was being paid to him by reason of the fact that due to war conditions he was the only active copartner in the business of the partnership at that particular time. A copy of said agreement is attached hereto marked Exhibit "C" and made a part hereof.

(f) One of the principal assets of the partnership was an undivided interest in a 300-acre vineyard and orchard which was acquired on February 8, 1943. The title to said vineyard and orchard was vested as follows:



1/8 undivided interest in Floyd J. Harkness, Sr., petitioner's husband;

1/8 undivided interest in Molly A. Harkness, taxpayer;

1/8 undivided interest in Floyd James Harkness, Jr. and his wife;

1/8 undivided interest in Harriet Harkness Colgate and William H. Colgate, Jr., her husband.

The other 1/2 interest in said property was owned by Chris A. Sorensen (a former partner of United Packing Co.) and his wife.

One-half of the profits from the operation of the vineyard and orchard inured to the benefit of the partnership and was reported as such in the partnership income tax return. This one-half of the profits for the year 1943 amounted to the sum of \$60,309.92, all of which profits were re-allocated by the respondent to petitioner and her husband, Floyd J. Harkness, instead of having been apportioned among the owners of said property on a partnership basis as reported in the income tax returns of the partnership and the respective income tax returns of the partners.

(g) In September, 1944, said William H. Colgate, Jr. received a medical discharge from the United States Army, and he thereafter immediately entered the services of the United Packing Co., and has devoted his entire time and attention since said date to the business and interests of the said United Packing Co.

(h) On January 6, 1946, Floyd James Harkness, Jr. was discharged from the United States Army,

and he thereafter immediately entered the services of the United Packing Co., and has devoted his entire time and attention since said date to the business and interests of the said United Packing Co.

Wherefore, petitioner prays that this Court may hear this proceeding and determine that the respondent erred in re-allocating the income of the partnership known as United Packing Co., and in such re-allocating to the petitioner and the petitioner's husband, Floyd J. Harkness, on a community property basis the entire income from said partnership, thus increasing the taxable income of the petitioner by the sum of \$71,770.50, and that this Court should determine that the correct amount of the petitioner's income tax and victory tax liability for the said year be re-computed in accordance with Rule 50.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ LeROY H. GUNTHER,

Counsel for Petitioner.

State of California,  
County of Fresno—ss.

Molly A. Harkness, being first duly sworn, deposes and says:

That she is the petitioner above named; that she has read the foregoing Petition and is familiar with the statements contained therein, and that the statements contained therein are true except those stated

to be upon information and belief, and that those she believes to be true.

/s/ MOLLY A. HARKNESS.

Subscribed and sworn to before me this 29th day of October, 1947.

[Seal] /s/ HARRY R. BRADLEY,  
Notary Public in and for the County of Fresno,  
State of California.

Exhibit "A"

Treasury Department  
Internal Revenue Service  
74 New Montgomery Street  
San Francisco 5, California

Aug. 21, 1947

Office of  
Internal Revenue Agent in Charge  
San Francisco Division  
IRA:90-D-DMA  
Mrs. Molly A. Harkness  
3767 Huntington Boulevard  
Fresno, California

Dear Mrs. Harkness:

You are advised that the determination of your income and victory tax liability for the taxable year ended December 31, 1943, discloses a deficiency of \$64,781.64, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington 25, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, San Francisco, California, for the attention of Conference Section. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

/s/ GEO. J. SCHOENEMAN,  
Commissioner,

By /s/ F. M. HARLESS,  
Internal Revenue Agent in  
Charge.

Enclosures:

Statement

Form of waiver

DMR 8-21-47



## Statement

San Francisco

IRA:90-D-DMR

In re: Mrs. Molly A. Harkness  
3767 Huntington Boulevard  
Fresno, California

Tax Liability for the Taxable Year Ended  
December 31, 1943

*Deficiency*

Income and Victory Tax.....\$64,781.64

In making this determination of your income and victory tax liability, careful consideration has been given to your protest dated December 23, 1946, and to the statements made at the conference held on April 21, 1947.

A copy of this letter and statement has been mailed to your representative, Mr. Philip S. Ehrlich, 2002 Russ Building, San Francisco 4, California, in accordance with the authority contained in the power of attorney executed by you and on file with this office.

## Statement for Year 1942

No change is made in income as reported on your return.

Tentative income tax liability reported. . . . \$37,095.33

## Adjustments to Net Income

Year: 1943

	Income Tax Net Income	Victory Tax Net Income
Net income as disclosed by return .....	\$108,821.85	\$114,858.88
Unallowable deductions and additional income:		
(a) Partnership income .....	\$71,770.50	\$71,770.50
(b) Contributions .....	25.00	0.00
	<hr/> 71,795.50	<hr/> 71,770.50
Total .....	\$180,617.35	\$186,629.38
Nontaxable income and additional deductions:		
(c) Interest .....	\$ 144.20	\$ 0.00
(d) Taxes .....	227.80	
(e) Business expenses .....	108.45	108.45
	<hr/> 480.45	<hr/> 108.45
Net income as adjusted .....	<u>\$180,136.90</u>	<u>\$186,520.93</u>

## Explanation of Adjustments

(a) On December 31, 1942, you and your husband, Floyd J. Harkness, together with your two children, Floyd James Harkness, Jr., and Harriet Harkness Colgate, executed an instrument purporting to create a family partnership. Since Floyd James Harkness, Jr., and Harriet Harkness Colgate contributed no capital originating with themselves, rendered no services to the business, and were not required to participate in the control and management of the business under the terms of the alleged partnership agreement, it is held that they did not acquire valid partnership interests in the United Packing Company. Accordingly, profits from the above-named organization are reallocated to you and your husband on a community property basis, thus increasing your taxable income by \$71,770.50 as shown below.

Total net profit of United Packing Company .....	\$361,832.00
Your community one-half share .....	180,916.00
Amount reported on return .....	109,145.50
Adjustment—increase .....	<u>\$ 71,770.50</u>

(b) Deduction for contributions is decreased by  
\$25.00 as follows:

Total charitable contributions .....	\$ 550.00
Your one-half community share .....	275.00
Amount claimed on your return .....	300.00

Adjustment—decrease .....	<u>\$ 25.00</u>
---------------------------	-----------------

Explanation of Adjustments  
(Continued)

(c) (d) and (e) Deductions of \$144.20, \$227.80 and \$108.45 are allowed for interest, real estate taxes and business expenses, respectively, as shown below since the items represent community deductions, one-half of which are deductible by you.

	Interest	Real Estate Taxes	Business Expenses
Total amounts paid .....	\$288.41	\$455.60	\$216.90
Your community one-half share .....	\$144.20	\$227.80	\$108.45

Computation of Tax  
Year: 1943

Income tax net income .....	\$180,136.90
Less: Personal exemption .....	1,100.00
Surtax net income .....	\$179,036.90
Less: Earned income credit .....	1,400.00
Balance subject to normal tax .....	\$177,636.90
Normal tax at 6 per cent on \$177,636.90.....	\$ 10,658.21
Surtax on \$179,036.90.....	122,159.89
Total income tax .....	\$132,818.10
Victory tax net income .....	\$186,520.93
Less: Specific exemption .....	624.00
Income subject to victory tax .....	\$185,896.93
Victory tax before credit (5 per cent of \$185,896.93) .....	\$ 9,294.85
Less: Victory tax credit .....	500.00
Net victory tax .....	8,794.85
Income and victory tax for 1943 .....	\$141,612.95
Income tax for 1942 .....	\$ 37,095.33
Amount of 1942 or 1943 tax, whichever is larger .....	\$141,612.95
Forgiveness feature:	
Amount of 1942 or 1943 tax, whichever is smaller	\$37,095.33
Amount forgiven (¾ of \$37,095.33) .....	27,821.50
Amount unforgiven .....	9,273.83
Correct income and victory tax liability .....	\$150,886.78

Computation of Tax  
(Continued)

Correct income and victory tax liability (Brought forward) .....	\$150,886.78
Income and victory tax disclosed by return; page 4—line 20 (Original, Account No. 359238 First California District) .....	86,105.14
Deficiency of income and victory tax .....	<u>\$ 64,781.64</u>

Exhibit "B"

Articles of Co-Partnership

These Articles of Co-Partnership, made and entered into this 31st day of December, 1942, by and between Floyd J. Harkness, first party, Molly A. Harkness, second party, Floyd James Harkness, Jr., third party, and Harriet Harkness Colgate, fourth party, the first, second and third parties being residents of the County of Fresno, State of California, and fourth party being a resident of Columbus, Franklin County, Ohio:

Witnesseth:

That the said parties hereto for themselves, their heirs, executors, administrators and assigns agree to become co-partners in the business of carrying on a general business of growing, packing, shipping and distributing of fresh fruit and vegetables in the State of California, including the purchasing and selling of any and all kinds of real and personal property necessary in carrying on and conducting said business, and said business shall be conducted under the firm name and style of "United Packing Co." from January 1st, 1943, until such time as the said co-



partners shall mutually agree to dissolve said co-partnership, or the said co-partnership shall be otherwise as hereinafter provided dissolved, and that the terms upon which the said parties have entered into said co-partnership are hereinafter stated as follows, to-wit;

That the said business of growing, packing, shipping and distributing of fresh fruit and vegetables and any other business which shall be incidental and necessary thereto, shall be carried on in the State of California, and that the principal place of business of said co-partnership shall be in the Rowell Building in the City of Fresno, County of Fresno, State of California or at any other place or places as the partners shall hereafter determine and that the firm name and style of said co-partnership business shall be United Packing Co., with real and personal property belonging thereto located in the Counties of Kern, Tulare, San Joaquin and Fresno, State of California.

It is understood and agreed by and between the parties hereto that said first party has been conducting the above mentioned business individually under the firm name and style of United Packing Co., and that he and Molly A. Harkness, his wife, second party herein, have been the owners of all the real and personal property, equipment and materials that are now used in carrying on said business, together with such moneys as may now be on deposit in the name of the said United Packing Co. and together with any and all outstanding accounts owing as of this date, the said Floyd J. Harkness and Molly A.

Harkness, first and second parties herein, do by these presents, sell, convey and set over, an undivided one-fourth partnership interest in and to all of the partnership property of the United Packing Co. to each of the third and fourth parties, namely, Floyd James Harkness, Jr. and Harriet Harkness Colgate, and from this date on each of the said co-partners above named, shall be and become the owners of an undivided one-fourth interest of all of the property of the said co-partnership doing business under the firm name and style of United Packing Co., and that the real and personal property which shall compose the capital of the said co-partnership and belong to the newly organized co-partnership is described in a Schedule marked Exhibit "A" and attached hereto and made a part of this agreement as if herein fully set out, and that there shall also belong to said co-partnership any and all other assets which now belong to said co-partnership and are not herein described as well as any and all other assets which may hereafter belong to said co-partnership; that all thereof shall belong equally to all of the partners herein named and in consideration of said first party conveying all of said real and personal property to said co-partners being conducted under the firm name and style of the United Packing Co., and which is agreed to be of the net value of \$138,241.61, that the said third and fourth party shall each execute in favor of first party a promissory note in the sum of \$34,560.40, payable in the manner as therein set forth to first party, and which sum shall be the purchase price for their undivided one-fourth interest in and to all of the assets of said co-partnership.

It is understood and agreed by and between the parties hereto that the said first and second parties are husband and wife and that all of the property which said first party is on this date conveying to the newly formed co-partnership, in which all of the above named parties are equal partners, has been accumulated by first and second parties during their married life and is the community property of first and second parties and that one-half thereof, by reason thereof, is the property of said second party and that the said second party does herewith join first party in the conveying of all of the said assets herein described to the said co-partnership so that from this date on, all of the said property now belonging to the said United Packing Co. and any and all other property which may hereafter belong to said co-partnership shall be owned equally by all the said co-partners.

It is understood and agreed by and between the said co-partners that said first party shall be, and is from this date on made the general manager of said co-partnership, and that he shall be in full charge of all business operations of said co-partnership and that he shall have the full right to conduct the business of said co-partnership in such manner as he may desire, including the selling of any and all of the partnership assets and the purchasing of such other property as he may desire in the name of said co-partnership together with the right to borrow such money as he may deem necessary to carry on said business and in consideration thereof it is understood and agreed that first party is to receive for his said



services a certain percentage of the net profit of said business to be agreed upon between all of the partners herein from time to time as they may agree upon between themselves, and that the balance of the net income of said co-partnership shall be equally divided between all of the co-partners herein at such time or times as they may agree upon, provided however that any profits which third and fourth parties are entitled to receive shall be paid to first party and applied by him first, to any payment which first party may have advanced to third and fourth parties, together with interest thereon and the balance thereof, if any, shall be applied by first party in the payment of the promissory notes which the said third and fourth parties have executed in favor of first party for the purchase price of their share in said co-partnership business.

It is understood and agreed that the said first party as general manager, and anyone of the other co-partners acting together shall have the right to bind the said co-partnership in such manner or form as they may deem necessary, in order to carry on the business of the said co-partnership, and that no other co-partner shall have the right to in any manner bind the said co-partnership, and that no co-partner shall have the right to in any way sell, assign, set over, transfer or hypothecate his undivided one-fourth interest in said co-partnership without first obtaining the written consent of two other co-partners.

It is understood and agreed that said first party as general manager of said co-partnership shall devote such portion of his time and attention to the



conducting and carrying on of said business, as he shall deem necessary and proper but that he will at all times use his own good judgment and best efforts and experience in carrying on said business for the best interests of all parties concerned and that second, third and fourth parties shall not devote any time or attention in carrying on said business unless hereafter agreed upon by and between any three of said co-partners and at that time it shall be agreed upon by and between any three of said partners as to what the compensation shall be for the services which third or fourth partner may contribute towards the carrying on of said co-partnership business.

It is understood and agreed that there shall be kept at all times a complete set of books of account wherein there shall be entered any and all records and transactions of said business and that the said first party shall have complete charge thereof and that said books shall be under his immediate supervision and that the said first party shall have the full charge of the collections and expenditures of all of the moneys received and taken in, in the carrying on of said business, and that all of the business transactions of said first party in carrying on said business shall be binding on all of the said co-partners.

It is understood and agreed in this connection that first party will render on the 1st of each year a true and full statement and account of the profits or losses of said business and all other matters and transactions done and performed in connection with said business.

It is understood and agreed by and between the parties hereto that upon the consent of the managing partner and two of the remaining partners that the capital of the partnership may be increased to such sum as may be determined by them, and that thereafter each of the partners shall contribute their respective share of the capital increase. In the event the managing partner and two of the other partners desire to reduce the capital of the partnership or withdraw profits, then such determination shall become binding upon all the partners hereto.

It is further understood and agreed by and between the parties hereto that each one of the partners will not, without the previous consent in writing of the other partners, enter into any bond or become bail or security for any person or persons or do or suffer to be done anything whereby the capital or property of the co-partnership may be taken by execution and that each partner shall punctually pay his own separate debts and should anyone of the said co-partners become financially involved in outside interests so that his share in the said co-partnership business shall become involved, and should anyone of said co-partners in any manner so become involved then the other co-partners shall have the right to acquire such insolvent partner's right, title and interest in said co-partnership at the book value thereof without any consideration of the good will of the said co-partnership and upon such transfer, such insolvent partner shall have no further right, title and interest in and to the capital assets of the said co-partnership.

It is understood and agreed that in the event that anyone of the said co-partners desire to sell or in any way dispose of their interest in the said co-partnership business, that then the remaining co-partners shall have the right to purchase such partner's interest in said co-partnership and then the selling co-partner shall convey all of his right, title and interest in and to the said co-partnership property to the remaining co-partners, and shall receive for such conveyed interest the book value of such interest at said time without any consideration of the goodwill of the co-partnership and that the amount which the selling co-partner shall receive may be paid in cash by the remaining co-partners, but if the remaining co-partners do not desire to pay cash for the selling partner's interest, then they shall have the right to pay such amount by the application of the profits from the business of such selling partner's share and that the same shall continue to be paid in this manner until the said purchase price of such selling partner's interest in said co-partnership shall have been paid in full, and then such selling partner shall execute in favor of the remaining co-partners a Bill of Sale conveying all of his right, title and interest in and to the said co-partnership business and assets to the remaining co-partners.

It is understood and agreed by and between the parties hereto that should anyone of the partners become deceased, that then the remaining co-partners shall have the right to purchase such deceased partner's share in said business at the book value at the time of the death of such co-partner without any consideration of the good will of the partnership and



such deceased partner's interest in said business shall be paid to the legal representative of such deceased partner and then the legal representative of such deceased partner's estate shall convey all of the deceased partner's right, title and interest in and to the said co-partnership property to the remaining co-partners and the legal representative of such deceased partner shall receive for such conveyed interest the purchase price for such deceased partner's interest which may be paid in cash by the remaining co-partners or if the remaining partners do not desire to pay cash for such deceased partner's interest, then they shall have the right to pay such amount by the application of the profits from the business of such deceased partner's interest and that this method of payment shall continue until the said purchase price of said deceased partner's interest shall have been paid in full and that upon such payment in full of the purchase price of said deceased partner's interest in said co-partnership the legal representative of such deceased partner shall execute and deliver to the remaining co-partners a Bill of Sale conveying all of the said deceased partner's interest in the said co-partnership business and assets.

It is also agreed by the co-partners that in the event of any misunderstanding between the co-partners concerning the matter of conducting and carrying on of said business that then the partners shall, between themselves adjust the same; it is however understood in this connection that the decision of the general manager and one other partner hereto shall determine any question which may arise be-



tween them and in the event that anyone or more of said co-partners should be dissatisfied with such decision then they shall have the right as given them by the laws of the State of California to bring proceedings in court for the purpose of either dissolving the said co-partnership or obtaining such relief as they are entitled under the terms of this co-partnership.

It is further understood and agreed that this co-partnership business is entered into on the proposition that each partner has an equal interest therein and is entitled to an equal share in all gains, profits and increases which shall come, grow or arise from, or by means of said business so long as such partner or partners shall not be in default in any of the terms of this agreement and that each partner shall be entitled to his one-fourth share of the said profits and that each partner shall likewise share equally in any losses which the said partnership may sustain and that each partner shall in the event it becomes necessary to furnish additional funds by reason of any losses which the said partnership may sustain, then each partner shall furnish and pay into the said business his equal share which may be necessary in order to continue on with the said co-partnership business. It being agreed that the decision of the managing partner and any two of the remaining partners shall be final as to the matter of the division of the profits and the amount which may be paid in by each partner in the event it becomes necessary to do so on account of losses sustained by the said co-partnership.

That at the end or sooner determination of their co-partnership, the said co-partners, each to the

other, shall and will make a true, just and final accounting of all things relating to their said business, and in all things truly adjust the same; and that all and every stock and stocks, as well as the gains and increase thereof, which shall appear to be remaining, either in money, goods, wares, fixtures, debts or otherwise, shall be divided between them, share and share alike.

In Witness Whereof, the above named partners have hereunto set their hands and signatures the day and year first above written.

.....

First Party.

.....

Second Party.

.....

Third Party.

.....

Fourth Party.

Financial Statement—United Packing Co.

1/1/43

Assets

Cash .....		\$100,000.00
Lodi Jap Camps .....		428.77
Packing Sheds .....	\$21,615.15	
Less: Depr. Reserve .....	15,966.41	5,648.74
Real Estate—Parlier .....		1,500.00
Registered Brands .....		1,230.00
Auto Equipment .....	9,025.96	
“ “ .....	2,925.58	6,100.38
Firebaugh Ranch .....	2,944.50	
“ “ .....	1,898.24	1,046.28
Otani Tractor .....	1,290.56	
“ “ .....	151.15	1,139.41
Box Making Machine .....	750.00	
“ “ .....	750.00	0
Peach Brushers .....	2,271.11	
“ “ .....	2,271.11	0
Paper Trays .....		504.18
Office Equipment .....	2,354.03	
“ “ .....	1,293.03	1,061.00
Packing Equipment .....	12,288.81	
“ “ .....	8,976.86	3,311.95
Picking Boxes .....		6,182.60
Packing Materials .....		6,473.31
Accounts Receivable:		
Andrews Bros. ....	164.50	
Benner Tea Co. ....	2,365.00	
H. H. Bennett .....	222.30	
Mrs. Blazer .....	575.00	
P. V. Cervantes .....	40.00	
P. B. Elter .....	74.45	
Goodman Vyd. ....	325.00	
M. Kozuki .....	519.03	
Mrs. Okjima .....	811.97	
Pete Dawson .....	2,430.00	
Ray Stevens .....	262.78	
Mrs. W. J. Welsh .....	444.40	
		8,234.43
		<u>\$142,861.03</u>

/s/ FLOYD JAMES HARKNESS,  
JR.,  
Third Party.

/s/ HARRIET HARKNESS  
COLGATE,  
Fourth Party.

Filed T. C. U. S., November 10, 1947.

---

[Title of Tax Court and Cause.]

### ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner admits and denies as follows:

1, 2 and 3. Admits the allegations contained in paragraphs 1, 2 and 3 of the petition.

4 and 4(a) to (e), inclusive. Denies that the Commissioner erred in the determination of the deficiency as alleged in paragraph 4 of the petition and subparagraphs (a) to (e), inclusive, thereunder.

5(a). Denies the allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b). Admits the allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) and (d). Denies the allegations contained in



subparagraphs (c) and (d) of paragraph 5 of the petition.

5(e). For lack of knowledge or information sufficient to form a belief, denies the allegations contained in subparagraph (e) of paragraph 5 of the petition.

(f), (g) and (h). For lack of knowledge or information sufficient to form a belief, denies the allegations contained in subparagraphs (f), (g) and (h) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ CHARLES OLIPHANT,  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

B. H. NEBLETT,  
Division Counsel;

T. M. MATHER,  
Special Attorney, Bureau  
Of Internal Revenue.

Received and Filed, T. C. U. S., December 16,  
1947.

[Title of Tax Court and Cause.]

### STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties through their respective counsel that the following facts are admitted without prejudice to the rights of either party to enter other and further testimony:

1. The petitioners are husband and wife who have maintained their family domicile in California for many years prior to 1943. Prior to December 31, 1942, the business and property of the United Packing Co. was owned and operated by Floyd J. Harkness and Molly A. Harkness. Molly A. Harkness by virtue of her marital rights has a 50% community property interest in the assets of the business. She has never performed any substantial services in connection with said business.

2. Floyd J. Harkness, Jr., and Harriet Harkness Colgate are the children of Floyd J. and Molly A. Harkness. The son attended various schools until June, 1941, when he graduated from college, majoring in commerce. Prior to that time he had worked through vacations in the business of his father and mother involving the growing, packing and distributing of fresh fruit and vegetables in the State of California. From June, 1941, until January, 1942, the son devoted his full services as an employee in the said business of United Packing Co., operating various district deals.

On January 12, 1942, he entered the United

States Army, from which he was not discharged until January 6, 1946. On December 31, 1942, he was twenty-five years old.

3. Harriet Harkness Colgate remained at school until June, 1942. Previous to that time she had performed occasional services of a clerical nature in said business during school vacations. In August, 1942, she was married to William H. Colgate, Jr., who was at that time serving in the United States Armed Forces, where he remained until 1944, at which time he received a medical discharge. Previous to his marriage to Harriet Harkness he had no connection of any kind with the United Packing Co.

During the year 1943 no services for the United Packing Co. were performed by Harriet Harkness Colgate nor by her husband. Nor did Harriet Harkness Colgate perform any services after 1943, although after his army discharge in September, 1944, William H. Colgate, Jr., devoted his full time and services to date to the business.

4. On December 31, 1942, an agreement entitled "Articles of Partnership" was executed by Floyd J. Harkness, Molly A. Harkness, Floyd J. Harkness, Jr., and Harriet Harkness Colgate, a true and correct copy of which is attached to the petitions in these proceedings and marked Exhibit "B."

A financial statement of United Packing Co. at January 1, 1943, showing the assets and liabilities of United Packing Co. as of January 1, 1943, is attached to Exhibit "B" in said proceedings as



Exhibit "A" thereof. The net worth or capital of said United Packing Co. on January 1, 1943, was \$138,241.61, and was the community property of Floyd J. and Molly A. Harkness at the time of the execution of said agreement marked Exhibit "B" attached to the petition filed in these proceedings. The assets of United Packing Co. did not constitute all of the assets of Floyd J. Harkness and his wife, there being two ranches which were excellent producers. These interests were individually retained by Floyd J. Harkness and his wife, Molly A. Harkness.

5. As provided in the agreement of December 31, 1942 (Exhibit "B" filed in these proceedings), Floyd J. Harkness, Jr., and Harriet Harkness Colgate each executed notes payable to their father, Floyd J. Harkness, Sr., which note in the case of Harriet Harkness Colgate was also executed and signed by William H. Colgate, Jr., the same being executed pursuant to the terms of said agreement. The notes were payable as provided in said partnership agreement. The note of Harriet Harkness Colgate and William H. Colgate, Jr., was for \$34,560.40. The note of Floyd J. Harkness, Jr., was for \$33,168.35. The sum of \$1,392.05, the difference between the two notes, is due to the credit standing on the books of United Packing Co. in favor of Floyd J. Harkness, Jr., consisting of the balance of bonuses and salaries to which he was entitled for work previously performed for United Packing Co. A statement from the books of United Packing Co.



showing the payment of the notes is hereto attached as Exhibit 1-A.

6. Under date of January 4, 1943, a supplement to the agreement of December 31, 1942, was executed, a copy of which is attached to the petition in these proceedings and marked Exhibit "C" therein.

7. On January 16, 1945, a supplemental agreement was entered into by and between Floyd J. Harkness, as first party, Molly A. Harkness, as second party, Floyd James Harkness, Jr., as third party, Harriet Harkness Colgate, as fourth party, and William H. Colgate, Jr., as fifth party, a copy of which agreement is hereto attached marked Exhibit 2-B and made a part hereof.

8. The volume of business handled by United Packig Co. and its predecessors in interest for the years 1937 to 1947, inclusive, in tonnage and dollar amount was as follows:

Year	Fruit Tonnage Shipped	Gross Proceeds
1937.....	9,435	\$ 415,016.70
1938.....	11,118	429,385.19
1939.....	15,266	547,176.48
1940.....	15,878	654,929.86
1941.....	15,453	808,627.12
1942.....	16,643	1,468,119.64
1943.....	15,113	2,572,905.53
1944.....	19,295	2,689,642.17
1945.....	16,575	2,365,742.51
1946.....	17,595	2,701,119.28
1947.....	24,718	2,578,967.40

The net income of the business of United Packing Co. and its predecessors in interest for the years 1937 to 1947, inclusive, was as follows:

1937.....	\$ 7,327.78
1938.....	15,551.51
1939.....	20,734.58
1940.....	29,470.38
1941.....	22,499.94
1942.....	141,790.95
1943.....	361,582.00
1944.....	321,765.79
1945.....	286,652.94
1946.....	234,939.00
1947.....	250,468.98

9. Compensation allocated to Floyd J. Harkness, Floyd J. Harkness, Jr., and William H. Colgate for the years 1943 to 1947, inclusive, was as follows:

	1943	1944	1945	1946	1947
F. J. Harkness....	\$75,000.00	\$75,000.00	\$75,000.00	\$75,000.00	\$75,000.00
Floyd J. Harkness, Jr....	.....	.....	.....	57,984.75	53,635.13
Wm. H. Colgate	.....	450.00	5,375.00	46,554.79	35,928.45

No compensation was paid to Molly A. Harkness or Harriet Harkness Colgate during said years.

10. Net profits, other than the salaries shown above, which were allocated to Floyd J. Harkness, Molly A. Harkness, Floyd J. Harkness, Jr., Harriet Harkness Colgate and William H. Colgate, Jr., on the books of United Packing Co. for the years 1943 to 1947, inclusive, was as follows:

	1943	1944	1945	1946	1947
F. J. Harkness....	\$71,645.50	\$61,578.94	\$51,569.48	\$13,849.86	\$21,476.35
Molly A. Harkness .....	71,645.50	61,578.95	51,569.48	13,849.86	21,476.35
Floyd J. Harkness, Jr....	71,645.50	61,578.95	51,569.48	13,849.87	21,476.35
Harriet Harkness Colgate .....	35,822.75	30,789.47	25,784.74	6,924.93	10,738.17
Wm. H. Colgate	35,822.75	30,789.47	25,784.75	6,924.93	10,738.18

11. On February 8, 1943, a 50% interest in a 300-acre vineyard and orchard was acquired by Floyd J. Harkness, Molly A. Harkness, Floyd J. Harkness, Jr., Harriet Harkness Colgate and William H. Colgate. The remaining 50% interest was acquired by Chris A. Sorensen, who was an employee of United Packing Co. All funds for the purchase of the vineyard were supplied by United Packing Co. and the amount loaned to Chris A. Sorensen was repaid to United Packing Co. by him. The 50% interest so acquired by Floyd J. Harkness, Molly A. Harkness, Floyd J. Harkness, Jr., Harriet Harkness Colgate and William H. Colgate was included as an asset of United Packing Co. and subsequent income therefrom was included in its net income. A copy of the deed and bill of sale showing said acquisition is hereto attached marked Exhibit 7-G.

12. In 1945, Sorensen discontinued his connection with United Packing Co. and sold his one-half interest in the 300-acre ranch to Floyd J. Harkness, Molly A. Harkness, Floyd J. Harkness, Jr., Harriet Harkness Colgate, William H. Colgate, Earl D. Harkness and Gladys M. Harkness, a copy of which agreement is hereto attached, marked Exhibit 3-C. An analysis of Chris A. Sorensen's income from the ranch above mentioned, as shown on the books of United Packing Co. is attached hereto marked Exhibit 4-D.

13. There is attached hereto marked Exhibit 5-E a Schedule which shows the participation over a period of time of persons employed by United



Packing Co. and its predecessors in interest in a managerial capacity from 1937 to 1947, inclusive, other than said partners of United Packing Co.

14. The capital accounts of Floyd J. Harkness, Molly A. Harkness, Floyd J. Harkness, Jr., Harriet Harkness Colgate and William H. Colgate, Jr., as shown by the books of United Packing Co. for the years 1943 to 1947, inclusive, attached hereto marked Exhibit 6-F.

15. Under date of January 11, 1946, a supplement to the agreement of December 31, 1942, was executed, a copy of which is hereto attached marked Exhibit 8-H.

16. Under date of January 24, 1947, a supplement to the agreement of December 31, 1942, was executed, a copy of which is hereto attached marked Exhibit 9-I.

Dated: January 7th, 1949.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ LeROY H. GUNTHER,

Counsel for Petitioner.

/s/ CHARLES OLIPHANT,

Chief Counsel,

Bureau of Internal Revenue, Counsel for Respondent.



Of Counsel:

B. H. NEBLETT,  
Division Counsel.

T. M. MATHER,  
Special Attorney, Bureau  
Of Internal Revenue.

Exhibit 1-A

United Packing Co.

1/ 2/43	Note Principal .....	\$34,560.40
	4% Interest .....	1,382.42
		<hr/>
12/31/43	Repaid (Harriet H. Colgate) .....	\$35,942.82
	(William H. Colgate, Jr.)	
1/ 2/43	Note Principal .....	33,168.35
	4% Interest .....	1,326.73
		<hr/>
12/31/43	Repaid (F. J. Harkness, Jr.) .....	\$34,495.08

EXHIBIT 2-B

This Supplemental Agreement, made and entered into this 16th day of January, 1945, by and between Floyd J. Harkness, first party; Molly A. Harkness, second party; Floyd James Harkness, Jr., third party; Harriet Harkness Colgate, fourth party, and William H. Colgate, Jr., fifth party.

Witnesseth:

That Whereas, the first four parties hereinabove mentioned did on the 31st day of December, 1942, enter into Articles of Co-partnership under the firm name and style of "United Packing Co.,"

And Whereas, the said Articles of Co-partnership provided among other things that the third and fourth parties hereinabove named were each to execute in favor of first party a promissory note in the sum of \$34,560.40, payable in the manner as therein set forth to first party, and which said sum was the purchase price for their undivided one-fourth interest in and to all of the assets of said co-partnership;

And it is now understood and agreed that the said third and fourth parties herein named have paid off the said promissory notes and all obligations which they are owing to first and second parties so that they are now each the owner of an undivided one-fourth interest in all of the assets of the said co-partnership without any indebtedness being attached thereto.

It is further understood and agreed that at the time of the execution of the said original partnership agreement, to wit, December 31, 1942, fifth party, namely, William H. Colgate, Jr., was the husband of fourth party herein, namely, Harriet Harkness Colgate, and was in the service of the armed forces of the United States government; and that he has now completed said service; and it is now agreed that the said William H. Colgate, Jr., shall become a co-partner in the said co-partnership as a participant in his wife, Harriet Harkness Colgate's one-fourth share of the partnership profits; and that until such time as the said third party, Floyd James Harkness, Jr., who is now serving in the United States armed forces, shall be

discharged therefrom, and shall become an active co-partner in the said business, that the said fifth party herein shall work for said co-partnership as a field man and shall receive for such services a regular field man's salary; and that this arrangement shall continue in full force and effect until the said third party, namely, Floyd James Harkness, Jr., shall return to active participation as a co-partner.

It is further understood and agreed that the said original co-partnership agreement dated December 31, 1942, between the first four parties herein named, provides that the said first party as general manager and any one of the co-partners acting together with the said first party should have the right to bind the said co-partnership in such manner or form as they may deem necessary in order to carry out the business of said co-partnership; and that said provision is hereby amended so that it shall now become necessary that first party as general manager and any two of the other co-partners acting together with said general manager shall have the right to so bind the said co-partnership.

It is further understood and agreed that the said original co-partnership agreement entered into between the first four parties hereto on December 31, 1942, contain a provision that in the event of any misunderstanding between the co-partners concerning the matter of conducting and carrying on of said business, that the decision of the general manager and one other partner shall determine any



question which may arise between the said co-partners; and it is now agreed that the said provision shall be amended so that in the event of any misunderstanding between the co-partners concerning the matter of conducting and carrying on of said business, that the decision of the general manager and any two other partners shall determine any such question, and their decision shall be binding upon the remaining co-partners, excepting that any one or more of the co-partners who shall be dissatisfied with such decision shall still have the right as given them by the laws of the State of California to bring proceedings in court for the purpose of obtaining relief as they are entitled to under the terms of the said co-partnership; the same as was provided in said original co-partnership agreement.

It is understood and agreed by and between the parties hereto that the said original Articles of Co-partnership dated December 31, 1942, shall remain in full force and effect except as herein modified by the Supplemental Agreement entered into on the 4th day of January, 1943, by the first four parties, hereto, and except as herein modified by this Supplemental Agreement.

In Witness Whereof, the parties hereto have hereunto set their hands and signatures the day and year in this agreement first above written.

FLOYD J. HARKNESS,  
First Party.



MOLLY A. HARKNESS,  
Second Party.

FLOYD JAMES HARKNESS,  
JR.,  
Third Party.

HARRIET HARKNESS  
COLGATE,  
Fourth Party.

WILLIAM H. COLGATE, JR.,  
Fifth Party.

EXHIBIT 3-C

This Agreement, made and entered into this 16th day of January, 1945, by and between Chris A. Sorensen and Katherine Sorensen, his wife, of the County of Fresno, State of California, parties of the first part, and Floyd J. Harkness, Molly A. Harkness, his wife; Harriet Harkness Colgate and William H. Colgate, Jr., her husband, and Floyd J. Harkness, Jr., nad Earl D. Harkness and Gladys M. Harkness, his wife, all of the same County and State, parties of the second part:

Witnesseth:

That said first parties, for and in consideration of the payments, covenants and agreements on the part of the second parties hereinafter contained, to be by second parties paid, kept and performed, do hereby agree to sell and convey unto second parties and second parties agree to buy, all those cer-

tain lots, pieces or parcels of land situate, lying and being in the County of Fresno, State of California and described as follows, to wit:

An undivided one-half interest in and to the following described real and personal property:

Parcel I:

All that portion of Section 5, Township 15 South, Range 23 East, M.D.B. & M., according to the United States Government Township Plats, described as follows:

Commencing at a point on the West line of said Section which is 316.5 feet southerly from the northwest corner of said Section 5; thence South  $10^{\circ} 56'$  East 99.8 feet to the center line of Cameron Slough; thence following the center line of Cameron Slough, as follows, to wit: South  $39^{\circ} 33'$  East 90 feet, South  $29^{\circ} 36'$  East 300 feet; South  $41^{\circ} 40'$  East 300 feet, South  $63^{\circ} 19'$  East 290 feet; North  $83^{\circ} 45'$  East 160 feet, South  $49^{\circ} 15'$  East 200 feet; South  $25^{\circ} 52'$  East 300 feet, South  $16^{\circ} 43'$  East 260 feet; South  $13^{\circ} 23'$  West 245 feet, South  $37^{\circ} 57'$  East 500 feet; South  $59^{\circ} 43'$  East 130 feet, South  $15^{\circ} 28'$  East 300 feet; and South  $7^{\circ} 24'$  East 490 feet to the center line of Kings River; thence South  $7^{\circ} 24'$  East to the intersection with the Government Meander Line, the same being the South boundary of Lot 10 of said Section 5, according to the Government Survey; thence westerly following the said Government Meander Line to the West line of said Section 5; thence northerly along the West line of said Section 5, to the point of commencement.

## Parcel II:

Commencing at the northeast corner of Section 6, Township 15 South, Range 23 East, Mount Diablo Base and Meridian, according to the United States Government Surveys, and running thence South 200 rods, to the center of Kings River; thence westerly up and along said center of said river to a point where said center of said river intersects with the center of North and South center line of said Section 6; thence North 10 chains, more or less, to the United States Segregation line North of said river; thence northwesterly along said Segregation Line to the southwest corner of Lot 2 of said Section 6; thence North 20 chains, more or less, to the northwest corner of said Lot 2; and thence East along the North line of said Section 60 chains to the place of beginning.

Also, that part of the South half of the northwest quarter of Section 6, Township 15 South, Range 23 East, M. D. B. & M. lying North of Kings River and South of the United States Segregation Line on the North side of Kings River; Excepting from the above land the following: Commencing at the northeast corner of Lot 2 (United States Government Survey and Plat), being also the one-quarter section corner on the North line of Section 6, Township 15 South, Range 23 East, Mount Diablo Base and Meridian; thence South along the half section line through said Section 6, 2251.8 feet; thence North  $47^{\circ} 49'$  West, 888.00 feet; thence North  $75^{\circ} 37'$  West, 691 feet; thence North  $5^{\circ} 46'$  West 86.50 feet; thence East 16.00 feet to the southwest corner of



said Lot 2; thence North along the West line of said Lot 2, 1419.10 feet to the northwest corner of said Lot 2; thence South  $89^{\circ} 7'$  East along the North line of said Lot 2, being also the North line of said Section 6, 1320 feet to the point of commencement.

Together with any and all Riparian Water rights of the Kings River, which now are attached and belong to the above described real property.

Together with any and all rights of way for roads running from the northwest corner of grantors' property to Malaga Avenue which have heretofore been established by usage, agreements or deeds, and also any and all rights of way for telephone lines and power lines used in connection with the above described real property.

Together with the following described personal property:

Two mules and harness

Two horses and their harness

One Ford tractor

One disc and sulphur duster

One Case tractor

Two 10HP motors and two 5 inch pumps

One Goble disc

One Case plow

One unitiller

One Tractor spring harrow

One Bean spray machine

Three vineyard trucks

One 1000 gallon Butane tank

One Chevrolet truck

One 1937 Ford truck



One 1939 Ford truck

One tractor disc

Three-fourths mile telephone line

Power line

One new tractor brush rake

Two 550 gallon gas storage tanks with two pumps

One 1500 gallon gas storage tank

Together with horse tools and other implements consisting of one mower, plows, cultivators, rake and steel-wheel truck.

together with any and all other farm tools and equipment now located and used upon the above described real property.

It being understood and agreed that it is the intention of the said first parties to sell all of their right, title and interest in and to all of the personal property which the parties hereto obtained under a Bill of Sale from Shoichi Haranga dated January 16th, 1943.

Together with any and all other personal property which may have been placed on said premises to replace any of said personal property described in said Bill of Sale.

All of the above real and personal property for the sum of \$75,000.00, which said sum shall be paid as follows: \$25,000.00 in cash upon the execution and delivery of this contract, receipt whereof is hereby duly acknowledged and the balance of said purchase price, to-wit, \$50,000.00, together with interest thereon at the rate of 11½% per annum from date hereof, shall be paid by the said second parties paying to

first parties 20% of the gross income received from all of the crops produced on said premises the first payment thereof to be made by January 5, 1946, and thereafter the said payment shall be made on January 5th of each and every year until the said purchase price and interest shall have been paid in full; it is however understood and agreed that said second parties shall have the right to pay the unpaid balance of principal and interest at any time they may desire and should the entire balance be paid before January 16th, 1946, then first parties will waive the payment of any interest, and second parties will then pay any and all expenses in connection with the execution of the deed, continuation of certificate of title and all legal expenses.

It is understood and agreed that all buildings, structures and improvements on said premises or any which may hereafter be placed thereon, shall become appurtenant to the land and none thereof shall be removed without first parties written consent.

It is understood and agreed that said second parties shall from this date on be entitled to the possession and occupancy of said premises and to any and all crops which from this date on may be produced on said premises and it is further understood and agreed that said second parties will farm the said premises in a good and farmerlike manner and according to the usual good farming practices in that neighborhood.

It is understood and agreed that the taxes on said premises, including the second installment of 1944-

45 State, County and School taxes have been paid and the water taxes for 1945 have been paid and that the same shall not be prorated and thereafter second parties shall pay all taxes and assessments levied on the above described property.

It is understood and agreed that this agreement includes the transferring of all of first parties right, title and interest in the title to 500 shares in the Muscat Cooperative Winery located between Kingsburg and Selma and from this date on said shares of stock shall become the sole and separate property of second parties, provided however that second parties will, on this date assign to said first parties 50% of all payments to be made on account of delivery of grapes from the above described premises during the years 1943 and 1944 to said winery.

It is also understood and agreed that some of the grapes produced on said premises have been delivered to the Sanger Winery Association and that as the payments are made by the Sanger Winery Association to second parties the same will be divided promptly and a check mailed to first parties for their one-half interest therein and that the money which either party hereto may collect from Young Yoon on account of crops which have been sold to him by the parties hereto during the year 1944, from the above described premises, shall be equally divided between the parties hereto and one-half thereof shall be remitted by the party collecting the same to the other party upon receipt thereof; it being understood and agreed that second parties will give to first parties a statement for the tonnage



delivered to the Muscat Cooperative Winery and the Sanger Winery Association upon the execution of this agreement.

It is understood and agreed that first parties hereto and some of second parties have been jointly operating the above described real property since the purchase of the same, and that there is now in the partnership fund the sum of \$15,000.00 in cash and that there shall be deducted out of this fund all of the expenses which have been incurred in operating the above described premises up to and including January 16th, 1945, and then the balance thereof shall be equally divided between the parties hereto as well as any additional income which has been received to date hereof.

It is also understood and agreed that any expenses commencing with January 17, 1945, shall be paid for by the said second parties and should any further bills turn up for the operating of said ranch properties which are not now known in connection with the operation of said premises, then the same shall be paid for by second parties, save and except that when the parties hereto receive from their insurance carrier a statement covering the labor compensation insurance on said ranch up to January 17th, 1945, that then one-half thereof shall be paid by first parties to second parties.

It is understood and agreed that in the event second parties, during the term of this contract, decide to dispose of said premises, that then first parties shall execute and deliver a deed to all of their right, title and interest in and to the above



described property and shall then be entitled to receive a promissory note for the balance of the unpaid purchase price for the real and personal property and said note or notes shall be secured by a first trust deed on the above described premises, and it is agreed that first parties shall not convey title to their one-half interest in said property to any other person or persons, excepting second parties or second parties assigns, without the written consent of said second parties.

It is understood and agreed that when said second parties shall have paid the said \$75,000.00 together with interest thereon, the purchase price of the real and personal property, and any and all other sums which may be owing first parties under the terms of this contract, and when second parties shall have otherwise complied with all of the terms and conditions on their part to be kept and complied with, then first parties, or their heirs or assigns will execute and deliver to second parties or to their heirs or assigns, a good and sufficient deed of Grant, Bargain and Sale, conveying the said premises to the second parties free and clear of any and all encumbrances made, done or suffered by first parties, and it is understood and agreed that first parties will execute and deliver to second parties a Bill of Sale to all of the above described **personal property**, conveying first parties undivided one-half interest therein to second parties. First parties further agree that they will, at the time of the delivery of said deed to second parties, continue to date of said deed, a certificate of title to said premises showing

said premises to be free and clear of any and all encumbrances made, done or suffered by first parties, excepting any and all reservations and rights of way which were of record on February 24th, 1943, the date of the title insurance issued by the Title Insurance and Guaranty Company on that date to the parties hereto, and the said certificate of title shall then become the property of second parties.

It is understood and agreed by and between the parties hereto that in the event that said second parties should fail, neglect or refuse to keep or comply with any of the terms of this contract on their part to be kept and complied with, then first parties may at their option, consider this contract terminated and at an end and shall cancel said contract and that they shall from said date on become the owners of the undivided one-half interest in said property, which they are, under this contract, selling to the said second parties, and second parties shall, at the option of first parties, forfeit all of their rights to the undivided one-half interest which the said first parties are by this agreement selling to second parties, and all money which second parties have heretofore paid under the terms of this contract shall be kept and retained by first parties and shall be deemed as a reasonable rental for the use and occupancy of said premises up to the time of such default, and first parties shall thereupon be released from all obligations in law or in equity to convey their one-half interest in said premises to second parties or to their heirs or assigns.

It is further understood and agreed by and be-

tween the parties hereto that from this date on second parties shall be responsible for any and all debts or claims arising out of the farming operations on said premises and the harvesting of said crops and any and all other operations of any and all kinds whatsoever which may arise out of the operating of said ranch properties.

In the event of suit on this contract for noncompliance with the terms hereof by either party the court having jurisdiction shall allow the successful party a reasonable attorney fee in such suit, to be made a part of the judgment therein.

It is understood and agreed that the stipulations aforesaid are to apply to and bind the heirs, executors, administrators and assigns of the respective parties hereto and that time is of the essence of this contract.

In Witness Whereof, the parties hereto have hereunto signed their names and executed these presents in triplicate the day and year first above written.

/s/ CHRIS A. SORENSEN,

/s/ KATHERINE SORENSEN,

First Parties.

/s/ FLOYD J. HARKNESS,

/s/ MOLLY A. HARKNESS,

/s/ HARRIET HARKNESS

COLGATE,

/s/ WILLIAM H. COLGATE,

JR.



/s/ FLOYD JAMES  
HARKNESS, JR.,  
By /s/ FLOYD J. HARKNESS,  
His Attorney in Fact.  
/s/ EARL D. HARKNESS,  
/s/ GLADYS M. HARKNESS,  
Second Parties.

(All signatures acknowledged January 17, 1945, before Julius Hansen, a Notary Public in and for the County of Fresno, State of California.)

EXHIBIT 4-D

Analysis C. A. Sorensen Income From River Ranch		
1943	50% share .....	\$60,309.92
1944	50% share .....	33,412.48
1945	50% share co-op payments crops delivered 1943-1944 .....	34,013.47
1946	50% share co-op payments crops delivered 1943-1944 .....	16,574.39
		<hr/> \$144,310.26 <hr/>
Book value—River Ranch as of 1/1/45 .....		\$64,290.59
		50%
C. A. Sorensen—50% share .....		32,145.30
C. A. Sorensen sold his 50% share to United Pkg. Co. for .....		74,500.00
C. A. Sorensen made capital gain on transaction of .....		42,354.70
* * * * *		
Deliveries From River Ranch to Co-Op Wineries:		
1944—Sanger Winery .....	731,000 lbs.	
1943—Sanger Winery .....	750,420 lbs.	
1944—Muscat Co-Op Winery .....	1,022,400 lbs.	
1943—Muscat Co-Op Winery .....	494,385 lbs.	
* * * * *		



United Packing Co.  
Bonuses Paid  
(in addition to regular monthl

[illegible]

*Molly A. Harkness vs.*

United Packing Co. Percentage Deals				
	C. E. Steiger (25% of net)	C. A. Sorensen (25% of net) (Clovis-Sanger) Fruit shipping operations only.	C. D. Wylie (50% of net Arvin)	H. Johnson (Lodi)
1947				
1946				
1945				
1944		38,569.17		
1943		53,283.59	11,634.63	
1942	4,275.91	23,989.03		1,933.79 (50/50)
1941	6,131.41	4,936.51		
1940	7,977.80	Straight Salary		
1939	5,772.17	Straight Salary		
1938	4,722.23	Straight Salary		661.06 (40% of net)
1937	3,706.31	Did not work		

C. A. Sorensen entered the shipping business in 1945, for himself as a competitor under his own name.

E. L. Barr, former district manager for United Packing Co. at Sanger, started a partnership with our leading grower of the Sanger District operating under the name of Barr & Droge, now operates as Barr Packing Co. This was begun in 1926 or 1927.

	R. A. Northrop 50%
1943.....	\$12,508.03
1944.....	16,848.20
1945.....	2,375.02
1946.....	13,808.52

During the above period, R. A. Northrop was employed by United Packing Co. as district field man for which he received a salary in addition to the above division of profits derived from leases of tokay vineyards, all of which were financed 100% by United Packing Co.

EXHIBIT 6-F

Floyd J. Harkness, Sr., and Molly A. Harkness  
Fresno, California

Year—1943		Withdrawals	Additions	Balance
1/12	Dr. Griffin .....	\$ 271.00		
14	Mutual Life .....	136.15		
2/ 1	Cash .....	230.00		
4	Cash .....	250.00		
24	M. J. Lockhart .....	100.00		
3/ 1	Cash .....	230.00		
20	Cash .....	50.00		
4/ 1	Cash .....	230.00		
16	Cash .....	200.00		
5/ 3	Cash .....	230.00		
17	Union Central .....	44.35		
6/ 1	Cash .....	230.00		
5	J. H. Reiss .....	47.50		
25	War Damage Insurance .....	19.00		
30	Cash .....	200.00		
7/ 1	Traveler Insurance Co. ....	65.95		
15	Cash .....	230.00		
8/ 2	Cash .....	230.00		
9/ 4	Cash .....	230.00		
8	Cash .....	15,000.00		
10/ 4	Cash .....	230.00		
11/ 1	Cash .....	230.00		
5	County Taxes .....	455.60		
6	Cash .....	300.00		

## Floyd J. Harkness, Sr., and Molly A. Harkness—(Continued)

Year—1943 (Continued)		Withdrawals	Additions	Balance
17	Cash .....	\$ 50.00		
24	Cash .....	7,350.00		
12/ 3	Cash .....	230.00		
4	First Presbyterian Church .....	250.00		
14	Collector of Internal Revenue .....	95,946.97		
15	Cash .....	300.00		
20	McNeill .....	13.18		
24	Cash .....	200.00		
31	1943 Profit Participation—United Packing Co. F.J.H. ....		\$ 71,645.50	
31	1943 Profit Participation—United Packing Co. M.A.H. ....		71,645.50	
31	1943 Salary—Floyd J. Harkness, Sr. ....		75,000.00	
Total.....		<u>\$123,779.70</u>	<u>\$218,291.00</u>	<u>\$ 94,511.30</u>
Year—1944				
Total Withdrawals .....		\$ 31,680.67		
Credit to Increase Capital to \$65,000.00 .....		30,439.60		
Credit to Increase Capital to \$65,000.00 .....		30,439.59		
12/31	Profit from McNeill Ranch .....		208.37	
4/14	Cash .....		25,000.00	
5/17	Cash .....		20,000.00	
12/31	1944 Profit Participation—United Packing Co. F.J.H. ....		61,578.94	
12/31	1944 Profit Participation—United Packing Co. M.A.H. ....		61,578.95	
12/31	1944 Salary—Floyd J. Harkness, Sr. ....		75,000.00	
Total.....		<u>\$ 92,559.86</u>	<u>\$243,366.26</u>	<u>\$150,806.40</u>
				<u>\$245,317.70</u>



## Year—1945

Total Withdrawals .....		\$172,694.44	
Dividend from Kings River Farm Loan Ass'n. ....			\$ 9.40
12/31	Profit from McNeill Ranch .....		859.27
12/31	1945 Profit Participation—United Packing Co. F.J.H. ....		51,569.48
12/31	1945 Profit Participation—United Packing Co. M.A.H. ....		51,569.48
12/31	1945 Salary—Floyd J. Harkness, Sr. ....		75,000.00
Total.....		\$179,007.63	\$ 6,313.19
			\$251,630.89

## Year—1946

1/ 5	C. S. Pierce & W. Byde Co. ....	\$ 12.30	
	Cash .....	325.00	
14	Collector of Internal Revenue .....	101,300.00	
15	Travelers & Mut. Ins. Co. ....	1,617.85	
2/ 1	Cash .....	325.00	
4	W. Byde & Co. ....	6.66	
23	Cash .....	150.00	
3/ 1	Cash .....	325.00	
2	Water Heater .....	42.80	
4	W. Byde & Co. ....	48.39	
7	Cash .....	50.00	
	Collector of Internal Revenue .....	11,302.41	
13	Collector of Internal Revenue .....	460.75	
	Santa Cruz Ld. ....	52.05	
14	Trustees of I.O.O.F. ....	375.00	
	J. A. Andrews .....	25.60	
15	W. E. Bauman .....	105.30	

Floyd J. Harkness, Sr., and Molly A. Harkness—(Continued)

Year—1946 (Continued)		Withdrawals	Additions	Balance
26	Cash .....	\$ 100.00		
4/ 1	W. E. Bauman .....	61.20		
2	Cash .....	325.00		
4.	W. Byde & Co. ....	23.18		
	Franchise Tax Commissioner .....	1,423.99		
	Pauls Plumbing .....	20.97		
5	Franchise Tax Commissioner .....	1,423.00		
8	Feller Planing Mill .....	81.80		
9	8# Butter .....	5.07		
15	Cash .....	700.00		
30	Cash .....	200.00		
5/ 1	Cash .....	200.00		
10	Cash .....	300.00		
16	Union Central .....	44.73		
6/ 1	Cash .....	400.00		
4	Collector of Internal Revenue .....	460.75		
	Traveler Insurance Co. ....	47.50		
22	Mrs. D. Fallbush .....	100.00		
26	Cash .....	250.00		
7/ 1	Cash .....	225.00		
3	Traveler Insurance Co. ....	65.95		
6	W. Byde & Co. ....	12.81		
10	Cash .....	200.00		
30	Cash .....	100.00		
8/ 1	Cash .....	400.00		
5	W. Byde & Co. ....	12.30		

6	State Income Tax .....	\$	2,846.99	\$	94.03	\$	31,686.48
12	Jim Hubner .....		300.00		830.16		
13	The Kliezoyen Co. ....		100.45		13,849.87		
18	Cash .....		337.50		13,849.86		
9/ 3	Cash .....		325.00		75,000.00		
9	Collector of Internal Revenue .....		460.75				
11	W. Byde & Co. ....		66.37				
	Roth Furniture .....		192.44				
10/ 1	Cash .....		325.00				
11	Cash .....		1,000.00				
11/ 1	Cash .....		367.50				
18	Cash .....		1,000.00				
26	County Taxes .....		546.69				
12/ 2	Cash .....		325.00				
	State Income Tax .....		2,846.99				
4	W. Byde & Co. ....		11.43				
14	Taxes—Santa Cruz .....		11.79				
	Insurance—McNeill Ranch .....		36.21				
16	Cash .....		500.00				
27	W. Byde & Co. ....		2.93				
	Selma Ranch Tractor Credit .....						
12/31	Profit—McNeill Ranch .....						
12/31	1946 Profit Participation—United Packing Co. F.J.H. ....						
12/31	1946 Profit Participation—United Packing Co. M.A.H. ....						
12/31	1946 Salary—Floyd Harkness, Sr. ....						
	Total.....		\$135,310.40		\$103,623.92		\$ 31,686.48
							\$219,944.41

[Italicized figures shown in red.]

Year—1947	Withdrawals	Additions	Balance
1/14	Travelers Insurance Co. ....	\$ 1,487.75	
	Mutual Life .....	130.00	
3/ 8	Payroll 3/7 .....	16.80	
5/14	Union Central .....	44.93	
	Prescott Lumber .....	35.89	
6/ 9	Collector of Internal Revenue .....	370.50	
12	J. H. Reiss—(Insurance) .....	47.50	
7/ 4	Travelers Insurance .....	65.95	
8/ 7	State Treasurer .....	2,106.37	
9/ 5	Collector of Int. Revenue .....	370.50	
9	W. Byde & Co. ....	41.09	
10/11	Aram's Appliance—Freezer .....	230.63	
11/13	First Presbyterian Church .....	100.00	
22	H. H. Gehrke—County Taxes .....	534.02	
12/ 3	State Treasurer .....	2,106.36	
12/31	Profit—McNeill Ranch .....	\$ 158.76	
12/31	1947 Profit Participation—United Packing Co. F.J.H. ....	21,476.35	
12/31	1947 Profit Participation—United Packing Co. M.A.H. ....	21,476.35	
12/31	1947 Salary—Floyd J. Harkness, Sr. ....	75,000.00	
	Total.....	\$ 118,111.46	\$ 35,423.17
	Balance — 12/31/47 .....		\$255,367.58
	Capital Set Up in 1944 .....		130,000.00
	Total Capital 12/31/47 .....		\$385,367.58



Floyd J. Harkness, Jr.  
Fresno, California

Year—1942	Withdrawals	Additions	Balance
12/31 Balance .....			\$ 1,412.05
Year—1943			
1/22 License—Dodge .....	\$ 20.00		
2/18 F. J. Harkness .....	1,392.05		
12/31 F. J. Harkness (Repay Note and Interest) .....	34,495.08		
12/31 1943 Profit Participation—United Packing Co. ....		\$ 71,645.50	
Total.....	\$ 35,907.13	\$ 71,645.50	35,738.37
			<u>\$ 37,150.42</u>
Year—1944			
7/ 8 War Bonds .....	\$ 300.00		
12/ 4 New York Life Premium .....	31.58		
12/31 Credit to Increase Capital to \$65,000.00 .....	30,439.60		
Money Order Received .....		\$ 300.00	
12/31 1944 Profit Participation—United Packing Co. ....		61,578.95	
Total.....	\$ 30,771.18	\$ 61,878.95	31,107.77
			<u>\$ 68,258.19</u>

## Floyd J. Harkness, Jr.—(Continued)

Year—1945	Withdrawals	Additions	Balance
1/10 Riggs Optical .....	\$ 11.28		
5/17 Ferrari-Nicker .....	21.78		
5/18 Riggs Optical .....	18.45		
5/25 War Bonds .....	600.00		
12/ 1 N.Y. Life .....	31.58		
Money Order Received .....		\$ 575.00	
1945 Profit Participation—United Packing Co. ....		51,569.49	
Total.....	\$ 683.09	\$ 52,144.49	51,461.40
			\$119,719.59
Year—1946			
1/11 Cash .....	\$ 125.00		
2/15 Cash .....	125.00		
2/28 Cash .....	125.00		
3/13 Collector of Internal Revenue (1946) .....	152.48		
3/30 Cash .....	250.00		
4/ 4 Franchise Tax Commissioner .....	2,522.95		
4/30 Cash .....	250.00		
5/28 Collector of Internal Revenue (1943) .....	41,423.52		
5/28 Collector of Internal Revenue (1944) .....	35,645.15		
5/31 Cash .....	250.00		
6/ 4 Collector of Internal Revenue (1946) .....	152.48		
6/14 Collector of Internal Revenue (1945) .....	28,654.87		
6/15 State Income Tax .....	3,781.78		

7/ 2	Cash .....	250.00		
7/31	Cash .....	250.00		
8/ 6	State Income Tax .....	632.06		
9/ 3	Cash .....	250.00		
9/ 9	Collector of Internal Revenue .....	152.48		
9/30	Cash .....	250.00		
10/31	Cash .....	250.00		
11/16	Southern Realty .....	3,000.00		
12/ 2	Cash .....	250.00		
	State Income Tax .....	632.05		
12/26	Cash .....	1,500.00		
	W. Byde and Company .....	7.32		
	Payroll Advance .....		\$	12.72
12/31	Repaid .....			7,132.32
12/31	1946 Profit Participation—United Packing Co. ....			13,849.87
12/31	1946 Salary—Floyd J. Harkness, Jr. ....	57,984.75		57,984.75
	Total.....	\$178,866.89	\$	78,979.66
				<u>99,887.23</u>
				<u>\$ 19,832.36</u>

Year—1947		
2/ 3	W. Byde Co. ....	\$ 34.06
3/ 3	W. Byde Co. ....	29.18
3/27	M. J. Lowell .....	28.00
4/ 3	Schultz Body Works .....	5.50

[Italicized figures shown in red.]

## Floyd J. Harkness, Jr.—(Continued)

Year—1947 (Continued)	Withdrawals	Additions	Balance
W. Hyde Co. ....	\$ 3.08		
5/14 Prescott Lumber .....	4.40		
5/19 W. E. Bauman .....	5.40		
6/ 3 Sorensen Machine .....	5.22		
6/ 4 Wagner Plumbing .....	28.50		
6/ 5 W. Hyde Co. ....	23.46		
Arams Appliance .....	128.64		
6/ 9 Collector of Internal Revenue .....	167.50		
8/ 7 C. S. Pierce Lumber .....	10.15		
9/ 5 Collector of Internal Revenue .....	167.50		
Payroll Advance .....		\$ 20.00	
12/31 1947 Profit Participation—United Packing Co. ....		21,476.35	
12/31 1947 Salary—Floyd J. Harkness, Jr. ....		53,635.13	
	53,635.13		
Total.....	\$ 54,275.72	\$ 75,131.48	\$ 20,855.76
Balance — 12/31/47 .....			\$ 40,688.12
Capital Set Up in 1944 .....			65,000.00
Total Capital — 12/31/47 .....			\$105,688.12



William H. and Harriet Harkness Colgate  
Fresno, California

Year—1943	Withdrawals	Additions	Balance
7/19 Cash .....	\$ 112.97		
9/13 Collector of Internal Revenue .....	1,070.89		
12/14 Collector of Internal Revenue .....	31,423.67		
12/31 F. J. Harkness (Repay Note and Interest) .....	35,942.82		
12/31 1943 Profit Participation—United Packing Co. ....		\$ 71,645.50	\$ 3,095.15
Total.....	\$ 68,550.35	\$ 71,645.50	\$ 3,095.15
Year—1944			
1/15 Cash .....	\$ 1,000.00		
3/13 Collector of Internal Revenue .....	217.21		
3/24 Santa Fe Tickets .....	59.16		
4/ 5 State Income Tax .....	666.19		
4/10 Collector of Internal Revenue .....	81.40		
6/ 7 S.P. Co. ....	114.58		
6/ 8 Cash .....	50.00		
6/12 Collector of Internal Revenue .....	81.40		
8/ 2 State Income Tax .....	666.19		
8/30 Santa Fe .....	143.99		
9/ 1 Collector of Internal Revenue .....	81.40		
12/ 5 State Income Tax .....	666.19		
12/31 Credit to Increase Capital to \$65,000.00 .....	30,439.60		
12/31 1944 Profit Participation—United Packing Co. ....		\$ 61,578.95	
12/31 William H. Colgate Salary .....	450.00	450.00	\$ 27,311.64
Total.....	\$ 34,717.31	\$ 62,028.95	\$ 30,406.79

## William H. and Harriet Harkness Colgate—(Continued)

Year—1945	Withdrawals	Additions	Balance
1/ 9	Collector of Internal Revenue .....	\$ 81.36	
1/13	Collector of Internal Revenue .....	14,013.14	
1/13	Collector of Internal Revenue .....	13,688.06	
2/ 3	Cash .....	1,000.00	
3/13	Collector of Internal Revenue .....	98.25	
4/11	State Income Tax .....	505.75	
6/11	Collector of Internal Revenue .....	98.25	
8/ 7	State Income Tax .....	505.75	
9/ 8	Collector of Internal Revenue .....	295.91	
12/ 1	State Income Tax .....	505.75	
12/31	1945 Profit Participation—United Packing Co. ....	\$ 51,569.49	\$ 20,777.27
12/31	William H. Colgate Salary .....	5,375.00	\$ 51,184.06
	Total.....	\$ 36,167.22	
Year—1946			
1/14	Collector of Internal Revenue .....	\$ 10,089.39	
	Collector of Internal Revenue .....	10,293.36	
1/24	San Joaquin Abstract .....	6,750.00	
2/ 5	Pauls Plumbing .....	35.55	
2/14	W. E. Bauman .....	81.00	
2/28	W. E. Bauman .....	110.70	
3/ 4	W. Hyde & Co. ....	51.15	
3/ 4	Central Rock .....	7.90	

3/ 5	Wagner Furniture .....	3.53
	Pierce Lumber .....	51.42
	Pierce Lumber .....	73.81
	Sanger Sash .....	60.07
3/ 8	Collector of Internal Revenue .....	1,498.01
3/ 9	Collector of Internal Revenue .....	1,469.48
3/13	Feller Planing Mill .....	6.50
	Collector of Internal Revenue .....	54.02
	Collector of Internal Revenue .....	30.28
3/16	Payroll .....	34.00
4/ 4	Traveling Comm. ....	390.74
	Wagner Plumbing .....	23.72
	Pauls Plumbing .....	17.22
4/ 9	8# Butter .....	5.07
6/ 4	W. E. Bauman .....	36.00
6/ 5	Collector of Internal Revenue .....	84.30
7/ 3	R. W. Weigann—Lawn Mower .....	29.58
7/ 6	W. Hyde & Co. ....	3.08
8/ 6	State Income Tax .....	390.74
8/24	Cash .....	1,000.00
9/ 6	Tramm Appliance .....	73.03
	Collector of Internal Revenue .....	84.30
9/14	Payroll 9/13 .....	36.80
10/ 5	Penny-Newman .....	1.80
12/ 2	State Income Tax .....	390.74

## William H. and Harriet Harkness Colgate—(Continued)

Year—1946 (Concluded)	Withdrawals	Additions	Balance
7/23 Check from H. Colgate .....		\$ 3,984.00	
12/31 1946 Profit Participation—United Packing Co. ....		13,849.86	
12/31 William H. Colgate Salary .....	\$ 46,554.79	46,554.79	\$ 15,433.43
Total.....	\$ 79,822.08	\$ 64,388.65	\$ 35,750.63
Year—1947			
1/14 W. E. Bauman .....	\$ 36.90		
2/28 W. E. Bauman .....	14.40		
3/10 S.P. Co. Tickets .....	379.62		
6/ 2 W. E. Bauman .....	1.80		
6/ 9 Collector of Internal Revenue .....	120.00		
12/31 Bill Smith Motors .....	34.15		
Payroll Advance .....		\$ 10.00	
12/31 1947 Profit Participation—United Packing Co. ....		21,476.35	
12/31 William H. Colgate Salary .....	35,928.45	35,928.45	20,899.48
Total.....	\$ 36,515.32	\$ 57,414.80	\$ 56,650.11
Balance .....			\$ 56,650.11
Capital Set Up in 1944 .....			65,000.00
Total Capital 12/31/47 .....			\$121,650.11

[Italicized figures shown in red.]



## Exhibit 7-G

## Grant Deed

Shoichi Haranga, also known as S. Haranaga, and Kimiye Haranaga, his wife, in consideration of Ten Dollars to them in hand paid, the receipt of which is hereby acknowledged, do hereby grant to Chris A. Sorensen and Katherine Sorensen, his wife, an undivided onehalf interest, and Floyd J. Harkness, Molly A. Harkness, his wife, Harriet Harkness Colgate and Floyd J. Harkness, Jr., an undivided one-half interest, in and to real property situated in the County of Fresno, State of California, described as follows:

## Parcel 1:

All that portion of Section 5, Township 15 South, Range 23 East, Mount Diablo Base and Meridian, according to the United States Government Township Plats, described as follows:

Commencing at a point on the West line of said Section which is 316.5 feet southerly from the northwest corner of said Section 5; thence South  $10^{\circ} 56'$  East 99.8 feet to the center line of Cameron Slough; thence following the center line of Cameron Slough, as follows, to wit: South  $39^{\circ} 33'$  East 90 feet, South  $29^{\circ} 36'$  East 300 feet, South  $41^{\circ} 40'$  East 300 feet, South  $63^{\circ} 19'$  East 290 feet, North  $83^{\circ} 45'$  East 160 feet, South  $49^{\circ} 15'$  East 200 feet, South  $25^{\circ} 52'$  East 300 feet, South  $16^{\circ} 43'$  East 260 feet, South  $13^{\circ} 23'$  West 245 feet, South  $37^{\circ} 57'$  East 500 feet, South  $59^{\circ} 43'$  East 130 feet, South  $15^{\circ} 28'$  East 300 feet and South  $7^{\circ} 24'$  East 490 feet to the center line of Kings River; thence South  $7^{\circ} 24'$  East to the intersection

with the Government Meander Line, to the same being the South boundary of Lot 10 of said Section 5, according to the Government Survey; thence westerly following the said Government Meander Line to the West Line of said Section 5; thence Northerly along the West line of said Section 5 to the point of commencement.

Parcel 2:

Commencing at the northeast corner of Section 6, Township 15 South, Range 23 East, Mount Diablo Base and Meridian, according to the United States Government Surveys, and running thence South 200 rods, to the center of Kings River; thence westerly up and along said center of said river to a point where said center of said river intersects with the center of North and South center line of said Section 6; thence North 10 chains, more or less, to the United States Segregation line North of said river; thence northwesterly along said Segregation Line to the southwest corner of Lot 2 of said Section 6; thence North 20 chains, more or less, to the northwest corner of said Lot 2; and thence East along the North line of said Section 60 chains to the place of beginning.

Also, that part of the South half of the northwest quarter of Section 6, Township 15 South, Range 23 East, M.D.B.&M. lying North of Kings River and South of the United States Segregation Line on the North side of Kings River; Excepting from the above land the following: Commencing at the northeast corner of Lot 2 (United States Government Survey and Plat), being also the one-quar-

ter section corner on the North line of Section 6, Township 15 South, Range 23 East, Mount Diablo Base and Meridian; thence South along the half section line through said Section 6, 2251.8 feet; thence North  $47^{\circ} 49'$  West, 888.00 feet; thence North  $75^{\circ} 37'$  West, 691 feet; thence North  $5^{\circ} 46'$  West 86.50 feet; thence East 16.00 feet to the southwest corner of said Lot 2; thence North along the West line of said Lot 2, 1419.10 feet to the northwest corner of said Lot 2; thence South  $89^{\circ} 7'$  East along the North line of said Lot 2, being also the North line of said Section 6, 1320 feet to the point of commencement.

Together with any and all Riparian Water rights of the Kings River, which are now attached and belong to the above-described real property.

Together with any and all rights of way for roads running from the northwest corner of grantors' property to Malaga Avenue which have heretofore been established by usage, agreements or deeds, and also any and all rights of way for telephone lines and power lines used in connection with the above-described real property.

Together with the appurtenances thereunto belonging,

Witness, our hands and signatures the 2nd day of February, 1943.

SHOICHI HARANAGA,

S. HARANAGA,

Also known as S. Haranaga.

KIMIYE HARANAGA,

Grantors.



State of Arizona,  
County of Pinal—ss.

On this 2nd day of February, 1943, before me, Ben T. Tsudama, a Notary Public in and for said County and State, personally appeared Shoichi Haranaga, also known as S. Haranaga and Kimiye Haranaga, husband and wife, known to me to be the persons whose names are subscribed to the within Instrument, and acknowledged to me that they executed the same.

Witness my hand and official seal.

BEN T. TSUDAMA,  
Notary Public in and for said County and State.

My commission expires Nov. 11, 1946.

### Bill of Sale

Know All Men By These Presents:

That We, Shoichi Haranaga, also known as S. Haranaga, and Kimiye Haranaga, his wife, formerly of the County of Fresno, State of California, but now residing in the State of Arizona, parties of the first part, in consideration of the sum of Ten Dollars, lawful money of the United States of America to them in hand paid by Chris A. Sorensen and Katherine Sorensen, his wife, and Floyd J. Harkness, Molly A. Harkness, Harriet Harkness Colgate and Floyd J. Harkness, Jr. co-partners, doing business under the firm name and style of United Packing Co., a co-partnership, parties of the second part, the receipt whereof is hereby acknowledged,



do by these presents sell and convey unto said second parties, their heirs, executors, administrators and assigns, that certain personal property situated in the County of Fresno, State of California, and described as follows:

Two mules and harness

Two horses and their harness

One Ford Tractor

One disc and sulphur duster

One Case tractor

Two 10-HP motors and two 5-inch pumps

One Goble disc

One Case plow

One Unitiler

One tractor spring harrow

One Bean spray machine

Three vineyard trucks

One 1000 gallon Butane tank

One Chevrolet truck

One 1937 Ford truck

One 1939 Ford truck

One tractor disc

Three-fourths mile telephone line

Power line

One new tractor brush rake

Two 550 gallon gas storage tanks with two pumps

One 1500 gallon gas storage tank

Together with horse tools and other implements consisting of one mower, plows, cultivators rake and steel-wheel truck. Together with any and all other farm tools and equipment belonging to gran-

tors now located upon the real property which grantors are selling to grantees located in Sections 5 and 6 in Township 15 South, Range 23 East, M.D.B.&M.

To Have and to Hold the same unto the parties of the second part, their heirs, executors, administrators and assigns forever.

And we do for our heirs, executors and administrators covenant and agree with the parties of the second part, their heirs, executors, administrators and assigns, to warrant and defend the sale of the said property, goods and chattels unto the parties of the second part, their heirs, executors, administrators and assigns against all and every person and persons whomsoever lawfully claiming or to claim the same.

In Witness Whereof, we have hereunto set our hands this 16th day of January, 1943.

SHOICHI HARANAGA,

S. HARANAGA,

Also Known as S. Haranaga.

KIMIYE HARANAGA,

Wife of Shoichi Haranaga.

State of Arizona,  
County of Pinal—ss.

On this 16th day of January in the year one thousand nine hundred and forty-three, before me, Ben T. Tsudama, a Notary Public in and for the County of Pinal, State of Arizona, residing therein, duly commissioned and sworn, personally appeared Shoichi Haranaga, also known as S. Haranaga, &

Kimiye Haranaga, his wife, known to me to be the persons whose names are subscribed to the within instrument and acknowledged to me that they executed the same.

In Witness Whereof I have hereunto set my hand and affixed my official seal in the County of Pinal, the day and year in this certificate first above written.

BEN T. TSUDAMA,

Notary Public in and for the County of Pinal,  
State of Arizona.

My commission expires Nov. 11, 1946.

EXHIBIT 8-H

This Supplemental Agreement, made and entered into this 11th day of January, 1946, by and between Floyd J. Harkness, first party; Molly A. Harkness, second party; Floyd James Harkness Jr., third party; Harriet Harkness Colgate, fourth party; and William H. Colgate Jr., fifth party,

Witnesseth

That Whereas the first four parties herein above-mentioned did on the 31st day of December, 1942, enter into Articles of Co-partnership under the firm name and style of "United Packing Co.", and

Whereas under and by virtue of the terms of a Supplemental agreement made and entered into on the 16th day of January, 1945, by and between the above-named parties, William H. Colgate Jr. fifth party, became a co-partner in the said co-partner-

ship as a participant in his wife Harriet Harkness Colgate's one-fourth of the partnership profits; and that the said Supplemental agreement further provided that the said fifth party should work for the said co-partnership as a field man and receive for such services a regular field man's salary until the said third party, namely Floyd James Harkness, Jr., should return to active participation as a co-partner; and it is now understood and agreed that the said third party, Floyd James Harkness Jr. has returned to Fresno, California, from his services in the United States armed forces, and that for the year 1946, the said fifth party, William H. Colgate Jr. is to receive as compensation for his services for working for said co-partnership 25% of the net profits of the Clovis and Sanger district deals; and 25% of the net profits from any other deals in which he is actively in charge; and it is now understood and agreed that the said third party, Floyd James Harkness Jr. has returned to active participation as a co-partner; and that he is for the year 1946 hereby appointed as Assistant Manager of all operations of the co-partnership; and that for his compensation for his services as Assistant Manager for the year 1946 he is to receive 25% of the net profits of the said co-partnership.

It is further understood and agreed that the first party is to continue to receive for the year 1946 for his services as Manager of the said United Packing Co. 75% of the net income from the said co-partnership up to the amount of \$100,000.00 net income of the said co-partnership; and that the parties hereto



shall after the payment of the above-named net profits to first, third and fifth parties receive their divisions of the balance of the net income in accordance with the terms of the said original Articles of Co-partnership and the modifications thereto wherein and whereby first party is to receive 25% of such net income; second party is to receive 25% of said net income; third party is to receive 25% of said net income; and fourth and fifth parties are to receive the other 25% of said net income.

It is understood and agreed by and between the parties hereto that the said original Articles of Co-partnership dated December 31, 1942, shall remain in full force and effect except as herein modified by the Supplemental Agreement entered into on the 4th day of January, 1943, by the first four parties hereto, and except as modified by the Supplemental Agreement entered into on the 16th day of January, 1945, by and between all of the parties hereto, and except as herein modified by this Supplemental Agreement.

In Witness Whereof the parties hereto have hereunto set their hands and signatures the day and year in this agreement first above written.

FLOYD J. HARKNESS,  
First Party.

MOLLY A. HARKNESS,  
Second Party.

FLOYD JAMES HARKNESS, JR.,  
Third Party.

HARRIET HARKNESS COLGATE,  
Fourth Party.

WILLIAM H. COLGATE, JR.,  
Fifth Party.

EXHIBIT 9-I

This Supplemental Agreement, made and entered into this 24th day of January, 1947, by and between Floyd J. Harkness, first party; Molly A. Harkness, second party; Floyd James Harkness Jr., third party; Harriet Harkness Colgate, fourth party and William H. Colgate Jr., fifth party,

Witnesseth:

That Whereas the first four parties herein above-named did on the 31st day of December, 1942, enter into Articles of Co-partnership under the firm name and style of "United Packing Co." and

Whereas under and by virtue of the terms of a supplemental agreement made and entered into on the 16th day of January, 1945, by and between the above-named parties, William H. Colgate Jr., fifth party, became a co-partner in the said co-partnership as a participant in his wife Harriet Harkness Colgate's one-fourth of the partnership profits; and thereafter on the 11th day of January, 1946, another supplemental agreement was entered into by and between the parties above-named for the reason that Floyd James Harkness Jr., third party herein, had returned to Fresno, California, from his service in the United States armed forces, and had re-

turned to active participation of a co-partner and was for the year 1946 appointed as the Assistant Manager of all operations of said co-partnership; and it was further provided in said supplemental agreement that the said William H. Colgate Jr., fifth party, was to receive for his services for working for said co-partnership 25% of the net profits of the Clovis and Sanger district deals and 25% of the net profits from any other deals in which he was actively in charge; and it is now understood and agreed for the year 1947 that William H. Colgate Jr. shall receive the same compensation for the same services for the year 1947; and that Floyd James Harkness Jr., third party is for the year 1947 to remain as Assistant Manager of all operations of the co-partnership; and that for his compensation for his services as Assistant Manager for the year 1947, he is to receive 25% of the net profits of said co-partnership after the payment to William H. Colgate Jr. compensation for his services as above provided.

It is further agreed that the said Floyd James Harkness, Jr., third party, and William Colgate, Jr., fifth party, shall each give his full time to the said co-partnership in the performance of his service for the said co-partnership as herein provided.

It is further understood and agreed that first party is to continue to receive for the year 1947 for his services as Manager of the United Packing Co. 75% of the net income from the co-partnership up to the amount of \$100,000.00 net income of the co-partnership after the payment to William H. Col-



gate Jr. compensation for his services as above-provided; and that the parties hereto shall after the payment of the above-named net profits to first, third and fifth parties, receive their divisions of the balance of the net income in accordance with the terms of the original Articles of Co-partnership and the modifications thereto wherein and whereby first party is to receive 25% of such net income; second party is to receive 25% of said net income; third party is to receive 25% of said net income; and fourth and fifth parties are to receive the other 25% of said net income.

It is understood and agreed by and between the parties hereto that the said original Articles of Co-partnership dated December 31, 1942, shall remain in full force and effect except as modified by the supplemental agreement entered into on the 4th day of January, 1943, by the first four parties hereto; and except as modified by the supplemental agreement entered into on the 16th day of January, 1945, by all the five parties hereto; and except as modified by the supplemental agreement entered into on the 11th day of January, 1946, by and between all of the parties hereto; and except as herein modified by this supplemental agreement.

In Witness Whereof the parties hereto have hereunto set their hands and signatures the day and year in this agreement first above written.

FLOYD J. HARKNESS,  
First Party.



MOLLY A. HARKNESS,  
Second Party.

FLOYD JAMES HARKNESS, JR.  
Third Party.

HARRIET HARKNESS COLGATE,  
Fourth Party.

WILLIAM H. COLGATE, JR.,  
Fifth Party.

Filed T.C.U.S., January 11, 1949.

---

The Tax Court of the United States

Docket No. 16407

MOLLY A. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

Docket No. 16408

FLOYD J. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

Courtroom,

U. S. Appraisers Building, San Francisco,  
California, Tuesday, January 11, 1949.

(Met pursuant to notice at 10 o'clock a.m.)

Before: HON: SAMUEL B. HILL,  
Judge.

Appearances:

PHILIP S. EHRLICH, Esq., and

R. J. HECHT, Esq.,

2002 Russ Building,

San Francisco, California,

and

LE ROY H. GUNTNER,

Security Bank Building,

Fresno, California,

Appearing on behalf of Petitioners.

T. M. MATHER, Esq.,

(Hon. Charles Oliphant, Chief Counsel,  
Bureau of Internal Revenue)

Appearing for the Respondent.

### PROCEEDINGS

The Clerk: Docket 16407, Molly A. Harkness;  
16408, Floyd J. Harkness.

Announce your appearances, please.

Mr. Ehrlich: Philip S. Ehrlich, R. J. Hecht, and  
Le Roy Guntner, representing the Petitioners.

Mr. Mather: T. M. Mather for the Respondent.

Mr. Hecht: May it please your Honor, I have not been admitted to practice before the Court. However, I signed an appearance, and I expect to file my application for admission seasonably with the Court in Washington.

The Court: Will you do that right away?

Mr. Hecht: Yes, your Honor.

The Court: All right. You will be permitted to appear in this case pending your admission on your application to be filed immediately.

Mr. Hecht: Thank you, your Honor.

The Court: State your case for the Petitioners. I take it these two docket numbers will be consolidated for hearing?

Mr. Ehrlich: I want to make a motion to that effect, if I may, your Honor.

The Court: They will be consolidated for hearing.

Make your statement for Petitioners.

## OPENING STATEMENT ON BEHALF OF THE PETITIONERS

By Mr. Ehrlich

Mr. Ehrlich: The Petitioners in this case are Floyd J. Harkness and his wife, Molly A. Harkness, residence, Fresno, California. These petitions arise out of the refusal of the Commissioner of Internal Revenue to recognize the co-partnership of Mr. and Mrs. Floyd J. Harkness, their son, Floyd Harkness, Jr., and their daughter, Mrs. Colgate, and son-in-law, William H. Colgate. However, William H.

Colgate, the husband, did not technically become a partner until 1945.

As the result of the Commissioner's refusal to recognize the partnership he assessed additional income and Victory Tax for the calendar year '43 in the sum of \$65,367.27 against Mr. Harkness, and against Mrs. Harkness a deficiency in the sum of \$64,781.64 for the same calendar year, '43. By his action the Commissioner has endeavored to place this co-partnership in the same category as the partnerships condemned by the Supreme Court in the Lusthaus and Tower Case.

We submit the Commissioner has committed an error. The evidence we intend to submit in support of the petition will, in our opinion, support a bona fide partnership for all purposes, not only legal but tax-wise.

The Court: Who were the partners according to your contention for the year 1943 here involved?

Mr. Ehrlich: Floyd Harkness, Sr., Molly Harkness, his wife; Floyd Harkness, Jr., and Harriet Harkness Colgate, his daughter.

The Court: Maybe I misunderstood your statement previously. One of the daughters—were there two?

Mr. Ehrlich: Just one daughter here. The son is Floyd Jr., the father Floyd Harkness, Sr., the mother Molly A. Harkness, and then the daughter, Harriet Colgate.

The Court: Which one was not technically a partner?



Mr. Ehrlich: The son-in-law in '43. He became a partner in '45.

The Court: So he is not involved in this proceeding here?

Mr. Ehrlich: That is correct. He became a partner in '45. We feel it has a materiality and bearing on the subject; that is why I mentioned it.

We feel there are good and sufficient business reasons for this partnership, and it was merely, as we see it, business reasons, which we will adduce in evidence, which prompted Mr. Harkness at this time to create this partnership as well as a desire to take care of his children. The circumstances which existed at this time as will be shown in the evidence, will establish clearly that the partnership was not created for the purpose of minimizing taxes.

It is also interesting to note that if the government is to prevail in this case, it must prevail because of the fact that the son, in any event, who had a draft exemption at the time waived that draft exemption, being he was a member of an essential industry, he waived that draft exemption and went to war. It is our contention if the position of the Commissioner is to be maintained it can only be maintained because of the fact that the son failed to take advantage of his draft exemption, went to war, and was penalized for going to war.

Mr. Harkness, to give your Honor a little background of the situation, Mr. Harkness, Sr., has been in the business of growing, packing, shipping and marketing fresh fruit and vegetables since the year 1917. The business involves acting as a com-

mission agent, as a factor for growers in the region, and this in turn required large financing by Mr. Harkness and his wife in connection with the purchase of fruits from growers. In addition, they grew some of their own commodities.

It is customary in this business, as will appear from the testimony, to lend money to growers in order to help them. As a result of the lending of this money you acquire the right to purchase their crops.

Mr. Harkness was married to Mrs. Harkness July 14, 1915, and the evidence will disclose neither of them has had any separate property, and it was as a result of the marital relations over a period of years that what we commonly call the United Packing, which is the partnership here before the Court, acquired the property which went into the partnership on January 1, 1943. Neither of them during their marital life have received any substantial gifts from any other source, and it is conceded by the stipulation, if your Honor please, that the assets of the partnership, the United Packing Company, which was organized by virtue of a technical legal document, was the community property of Mr. and Mrs. Harkness.

The Court: At the time of the organization of the partnership?

Mr. Ehrlich: That is correct your Honor.

The evidence further discloses that the business which is engaged in by this partnership, and I will have a map showing your Honor the area covered by the partnership, is doing business in what we

commonly call the San Joaquin Valley, and the partnership does business over an area of 250 miles. We think that is important as indicating the necessity for competent men to aid in the operation and management of this business which has spread over a wide area.

Evidence will disclose, if your Honor please, that in a business of this character, the farming business, particularly this type of business, buying and selling raw fruits, both on your own account and for the account of growers, that in order to attract capable personnel it has been necessary to let the personnel either have bonuses as a result of their efforts which they have contributed to the profits of the business, or to give them percentage deals. In this stipulation [8] we will point out to your Honor later we have set forth the percentage deals and bonuses which the United Packing—that is the name of the partnership, United Packing—over a period of years since its organization had been accustomed to give to key personnel, both bonus deals and percentage deals.

The evidence will also indicate, if your Honor please, that these bonus deals and these percentage deals were a continuous drain upon the partnership, and that it was required as a result of this method of doing business which was necessary to acquire these key men, that the partnership was continually in hot water financially and had to continuously engage in large borrowings. One of the motivating forces which induced Mr. and Mrs. Harkness, owners of the partnership at the time they created the



four-way partnership I have just explained, one of the motivating influences was the fact that they wanted this money which was being accumulated to remain in the business so they could grow; and with these percentage and bonus deals, this was impossible of accomplishment. Of course, during the years of unfavorable conditions, lack of money was a great drain, and as your Honor can understand, unless funds could be accumulated during periods of good business, this partnership and many of them in the San Joaquin Valley would always get into financial difficulty.

The evidence will further disclose that Mr. Harkness was employed by a fruit company in the San Joaquin Valley from [9] 1917 to 1920. He was born in Fresno and his whole life has been devoted to farming and agriculture.

From 1920 to 1923 he was employed by the Associated Fruit Company, and while with that company had a participation deal, bonus or percentage of the profits.

The evidence will further disclose that after he left the Associated Fruit Company he organized, together with a Mr. Jasper and Mr. Wilhelm, a partnership of their own, and the profits of this partnership were divided three ways. This one partnership lasted one year, and Mr. Wilhelm was through at the close of '23.

During the years '24 to '36 the business which I have explained to your Honor, strictly agricultural and buying and selling fruits and raising fruits to a lesser degree, consisted of Mr. Jasper and Mr.



Harkness. This partnership was terminated in 1936. So your Honor can clearly understand that Mr. Harkness has had one partnership after the other for the last more or less 30 years, having spent all his time in this particular activity.

At the time of the termination of the partnership relations between Mr. Jasper and Mr. Harkness, the activities of the partnership covered Madera, Fresno, Tulare, Kern, and San Joaquin Counties. During this period Mr. Jasper looked after the office, Mr. Harkness was what we call a field man, tended to the actual buying and selling, raising of crops. [10] The operations covered an area of some 250 miles; the head office was in Fresno.

As a result of the culmination of the partnership, Mr. Jasper took certain property and Mr. Harkness took certain property. Mr. Harkness took primarily the operation end of the game, and Mr. Jasper took the farms.

Even in the partnership between Mr. Jasper and Mr. Harkness which went from '24 to '36, bonus and participation deals were indulged in, the bonuses at that time running five to ten per cent, and participation of a substantial amount. The remaining profits were divided between Mr. Jasper and Mr. Harkness.

In 1937 after the dissolution, the business was conducted by Mr. Harkness, it being the community property of Mr. and Mrs. Harkness, and was called the United Packing Company.

Now that activity, that proprietorship as I designated, of Mr. and Mrs. Harkness jointly, all being

community property, continued from 1937 until December 31, 1942, when the partnership which the government has questioned here was created, again called the United Packing Company.

The Court: Up to that time they didn't conduct the business as a partnership, but simply on a community property basis?

Mr. Ehrlich: That's right. The proprietorship was run, Mr. Harkness managing the business, the business being [11] owned by Mr. and Mrs. Harkness equally as a result of the community property laws of the State of California.

Mr. Harkness had long realized, having gone through these long gyrations of partnership and percentage and participation deals, that it was essential if this partnership was to prosper and continue that money must remain in the business, and we will show that one of the motivating factors was this idea on his part to bring his family into the deal in order that he might adequately finance himself.

There was also another motivating factor in this deal: the fact that his son who had always lived on the farm—and by the way, the Harknesses from '29 to '39 or thereabouts, the evidence will show the dates, had a farm outside of Fresno, and their son and daughter lived on the farm—so these children, both the son and daughter, who subsequently became members of the partnership, had lived this farming life, and the evidence will also show that the son had worked for a long period of years. This was no new idea just clear out of a clear sky, but the

son had worked for his father during the greater portion of his life when he was not attending school. As a matter of fact, the evidence will show, if your Honor please, during the year 1937 when the father and mother needed his help in the United Packing Company, the son quit school from June, 1937, or thereabouts—the evidence will show the exact dates—until January, 1938, for the sole purpose of [12] helping his father and helping to manage the United Packing activities.

The evidence will also show that the son, after he graduated from college, came in and affiliated himself with the business.

The Court: What year was that?

Mr. Ehrlich: That was in June of '41, as I recall it, your Honor. The boy graduated from Fresno State College and affiliated himself with the partnership, and during the year '41 received a participation of five per cent in the profits of the partnership in addition to a small salary. It was in the summer vacation of '37 that the boy left school and did not return until January, '38, and remained with his father. The period in which they lived on a ranch was from '29 to '39. At the time, in the year '39, the boy was 21 years old.

The evidence will also show—I will have the father and son testify—that they had discussed on many occasions the boy's affiliation with the business, and the evidence will also show that at the time the boy voluntarily gave up his draft deferment and went into the service in January of 1942 that he had on the books of the partnership some



\$1,200 or \$1,300 still due and owing to him as a result of his service which had been rendered to the proprietorship. When I say "proprietorship" I don't want to confuse your [13] Honor; it is Mr. and Mrs. Harkness doing this business. When the son left for the service there was due and owing to him \$1,200 to \$1,300, which reduced the amount of the note which the son gave to the father and mother for participation in the business. The daughter paid, I think, some \$34,000, and the son paid \$34,000, less the credit of the amount due him on the books of the partnership.

The Court: What year were they taken into the partnership?

Mr. Ehrlich: They were taken into the partnership as of January 1, 1943. It was signed during December of '42 while the son and son-in-law were both in the service. Discussions, as I have pointed out, in this particular interest, had not only occurred between the father and son regarding his affiliation with the business, the financial position of the business as the result of the requirements to pay these large bonuses and percentages to strangers, but as to the ability of the business to succeed, and the son and father discussed this question of his participation in the transactions. As a matter of fact, the son asked to participate in 1941 and the father said that his bonus deals were too severe, that he couldn't permit him at that time, although he gave the son at that time a five per cent participation. In these discussions the son kept pressing his father, saying that he wanted to make this his



career, wanted to become identified with it. And [14] naturally, not only was it the business motive that prompted his father, but the parental relationship where the father was desirous of taking the son into the business so that the business which he had developed could be perpetuated.

More or less the same held true after the son-in-law—without going into too much detail in my opening statement—the same state of facts held true with reference to the daughter. The daughter, for example, had worked after she became of age in September of '41 and graduated from college June, '42, worked for three or four months in the father's business. She married in August of '42. Her husband had joined the Army before the draft law had become effective, and he was in the service. But the father and mother and daughter discussed that if the son was to come into the business equal treatment and opportunity should be given to her, and they discussed that. The father said whatever he did for the son, whether it was a loan, whatever participation, how he handled the matter, he would do the same thing for his daughter, the question being, which they discussed at considerable length, whether or not the son-in-law and daughter, or the daughter, should get the opportunity in the United Packing Company or whether she should invest elsewhere whatever her father loaned her or gave her, whatever way the transaction was finalized, whether she should take her interest in the partnership; and they also discussed other investments. [15] Due to the war conditions at that time, and the

trust and confidence she felt in her father's ability, she decided whatever opportunity her father made available to her should be made available in the partnership rather than in outside enterprise. The evidence will disclose there were certain other enterprises that she was thinking of at the time.

It will also disclose that Mr. Colgate, who was not technically a member of this partnership, doesn't become a member until he comes back from the service, had parents of means, and when it came to the question of financing their interest in this partnership, the money could have been available from Mr. Colgate's father, but they decided to borrow the money from Mr. Harkness, Sr., on a note. By the way, this partnership was created effective as of January 1, 1943, and Mr. Harkness, Jr., and Mrs. Colgate, the daughter, gave for their interest in this partnership, which was a 25 per cent interest, each gave a promissory note. The promissory note which Mrs. Colgate gave was signed by her husband, so that he had a tie of liability as well as his wife for the repayment of funds. As the evidence will establish, your Honor, these two notes, both the son's note and the daughter's and son-in-law's note were paid out of the profits, and proper credits; the books of account were kept with meticulous care.

The stipulation would indicate the capital account, the contributions of the partners, the withdrawals, the participations [16] and the salary.

I also want to point out to your Honor this in passing: that the partnership was created on January 1, 1943. The stipulation of facts shows that on

January 4, 1943, four days after the partnership became legally effective, a supplemental agreement was entered into which established the salary of Mr. Harkness, Jr., who was managing the partnership while the boys were away, and Mr. Harkness, Sr., for the years 1943, '44, '45, '46, and '47, as the stipulation establishes, received \$75,000 a year. It was 75 per cent, the stipulation establishes, and the contracts which are in the stipulation, but I say \$75,000 a year because that is the way it was computed; that is the way it came out. It was computed that Mr. Harkness, Sr., would receive 75 per cent of the profits of the first \$100,000, and then the partners came in and participated. It so happened in the five years Mr. Harkness, Sr., has received as salary and it has been credited to him on the books of the partnership, \$75,000 a year, so the question naturally arises: Isn't it a fact that if this partnership was created for tax purposes, Mr. Harkness, Sr., would have taken \$12,000 or \$25,000?

The Court: You are arguing your case now.

Mr. Ehrlich: I am sorry, your Honor.

While I am on this subject I want to state this: In the end of '44, Colgate, the son-in-law, received a medical [17] discharge, came back to Fresno County, and I think the evidence will establish that within a few days after his return to Fresno he became actively engaged in working for the January 1, 1943, partnership, and he received a nominal salary during the year 1944. I think he received some \$400 or \$500—the Wage Stabilization Order was in effect. On January 16, 1945, Mr. Colgate



became technically a member of the partnership, and a supplemental agreement, which is attached to the stipulation, made him a partner in the agreement, although he and his wife still shared the one-quarter interest. As a matter of fact, during the year 1945 he received some \$4,000 or \$5,000.

In '46 young Harkness came back and immediately affiliated himself immediately began working for the partnership, so in the years '46 and '47 they entered into contracts supplementing the original contract whereby the son-in-law and son received very substantial salaries. I think the evidence will show that the salaries which the son received in the year '46 when he came back from the Service and started contributing to the partnership——

The Court: Is that in the stipulation?

Mr. Ehrlich: Yes, your Honor.

The Court: Well, we will get it.

Mr. Ehrlich: But they received in '46 and '47, the two boys received between \$40,000 and \$50,000 each year, and [18] their participation in the profits on the percentage deal, which was the original theory upon which Mr. and Mrs. Harkness brought their son and son-in-law into the business.

In the years '43, '44, '45, '46, and '47 as a result of the percentage deal expressed in the written contracts—and I might emphasize here, your Honor, this partnership has been conducted with meticulous detail both as far as written documents are concerned, legally and accounting-wise—as a result



of these percentage deals, Harkness, Sr., received in 1943 \$75,000; '44, \$75,000; '45, \$75,000; '46, \$75,000; and '47, \$75,000 salary.

The boy was in the service '43, '44, and '45; started devoting his time and his ability to the partnership in '46, and received a salary of \$57,984.75 in '46; and in '47, \$53,635.13. That is all as the result of participations in the profits and not a fixed salary.

Now, the son-in-law, Mr. Colgate, as I pointed out to your Honor, came back in 1944, received \$450 for the few months he worked in '44 as a result of Wage Stabilization. He received \$5,375 in '45; in '46, \$46,554.79; and in '47 he received \$35,928.45. It is interesting to note, if your Honor please, the stipulation indicates that these years in which these three men received for services rendered some \$180,000 or thereabouts, the participation in the partnership for the year '46 was about—I am adding it hastily here—[19] about \$55,000, I mean all the partners received \$55,000 in '46 as their participation, and in '47 about \$83,000. So in those last two years the salaries of the partners far exceeded the participation of the partners in the profits.

The evidence will also disclose, if your Honor please, that at the time Mr. Harkness at the end of '42 started to seriously discuss this matter, that conditions were none too favorable. The stipulation shows that there had been a good year in 1941. However, the war effort had not begun, as your Honor knows, and may take judicial notice, to crystalize sufficiently to affect various activities, and

in and about the middle of August, '42, a number of Orders had been promulgated by the various administrative agencies, the President, War Production Board, and various agencies which had been organized to conduct the war, which created quite a doubt in the minds of Mr. Harkness and his wife as to the future of the business. Without going into that at length, I just want to call to your Honor's attention that there was a great scarcity of labor due to the fact that the Japanese were required to move from the Pacific Coast of California in particular, and labor in the San Joaquin Valley of this type of activity depended to a great extent upon Japanese. Then there was the large starting up of the shipyards and other manufacturing war activities that drained labor. There was priority on freight cars, material priorities affecting shooks, nails, wood. There were government [20] limitation orders with regard to repairs and use of materials. There was a raisin order whereby the government required that grapes be converted into raisins so that the government could stockpile raisins for the European countries. There was a sugar rationing order that affected the situation. Then there was this fact: there was the possibility that grapes which were not a vital commodity as it had been listed by the War Production Board and other agricultural agencies involved, that there was a freight car situation so that the matter was very questionable, the conditions which were facing this partnership.

It is also interesting to note that Mr. and Mrs.

Harkness did not turn over to the partnership all their assets. As of December 31, 1942, they were worth—I will introduce in evidence their balance sheet—\$235,000. The co-partnership started with assets of \$138,000, so that Mr. and Mrs. Harkness had retained in the partnership approximately \$100,000 out of \$250,000 of assets. Their idea was that they wanted to be protected in the event that anything happened to the partnership so that they had some other means. In the assets retained by Mr. and Mrs. Harkness as of January 1, '43, there were several ranches which they felt would be sufficient to support them. We will also introduce in evidence the income from these sources.

The Court: They had unlimited liability, didn't they?

Mr. Ehrlich: Yes, your Honor, as individuals they had [21] unlimited liability, and these assets could have been taken if the partnership had not been successful. But they felt that they wanted to keep those assets for their own use, not let the children participate in those particular assets, which, as the evidence will disclose, were \$50,000 in cash and these ranches.

There is only one other transaction which is contained in the stipulation which I desire to call to your Honor's attention in the opening statement, and that is this, illustrating the drain of outside personnel on the business. They had a man named Sorensen, a very able man in this particular activity. We have an exhibit here that shows as a result of Mr. Sorensen's participation in this business he



insisted that they buy a ranch west of the Harknesses, and they financed a ranch jointly with him. As a result of that joint venture he withdrew in a period of three or four years some \$150,000 in profits, then forced the Harknesses to buy the ranch from him and made a gain of some \$40,000 or \$50,000. This all occurred at the time that he severed relations, and I think the transaction was closed on the same day that young Colgate technically joined the partnership, as I told you, in January of '45. This man Sorensen at that time required the United Packing Company to buy him out of the partnership, and they bought him out. That merely indicates the drain which these outside factors had been on the business. [22]

In closing my opening statement I would like to state to your Honor that we have here the books of the partnership available. The stipulation shows the partnership withdrawals. As I pointed out before, the notes were paid off, this was not a gift, this is a community property partnership, there isn't a question of the wife having been gifted, so that we have a community property partnership originally; we have a sale by the father and mother to their children of this interest with notes, one of the notes being of a lesser amount than the other because of the credit on the books that the son had. We have here the books being kept in the strictest order. We have the capital accounts, there is no inter-family transaction, the profits available, the salaries available, the income tax returns indicate



that they all paid their taxes on their salaries and incomes, there has been no interplay of finances between the children and the father and mother.

We also have these large salaries which I pointed out to you, and I don't want to take the time of the Court, as we will point it out on the brief, but I emphasize it most strongly, and that is this: that these partnership agreements contained restrictions on the power and rights and obligations of the various partners, and particularly there is one provision I won't take the time to read as we will point it out to your Honor in briefs, whereby it required three partners to act on certain matters of vital interest to the partnership so that [23] neither Mr. or Mrs. Harkness could control the situation without any consideration, without giving any consideration to the children.

As a result of these factors which I have tried to skim over as hurriedly as possible so as not to take the time of the Court, I feel that we have a partnership which, if your Honor please, qualifies as a legitimate bona fide partnership for tax purposes, and that the tax returns as returned by the various partners are correct.

Thank you.

The Court: Mr. Mather.

## OPENING STATEMENT ON BEHALF OF THE RESPONDENT

By Mr. Mather:

If your Honor please, we think that the evidence in these cases will disclose that the family arrange-

ment for our taxable year was not dissimilar to a similar arrangement which the Supreme Court refused to recognize in the Tower and Lusthaus Cases. The evidence will fail to disclose any new capital came into the business; will fail to disclose that the children performed any service in the taxable year.

The evidence will disclose that the partnership agreement provided that the children weren't to perform any services in the taxable year. We are not much concerned with what went on before our taxable year. The evidence will disclose that this was community property of the Petitioners at the [24] time of this arrangement, our taxable year. Now, what transpired after our taxable year we are not much concerned with. Later the evidence discloses, long past our taxable year, that the son came back and devoted his time to the business. We don't have that question before us. We have the year 1943 at which time the son was in the Army, the daughter never at any time performed any vital services to the business, and we think it is just one of the typical family partnership cases.

The Court: Call your witness.

Do you want to offer your stipulation?

Mr. Ehrlich: Yes. If your Honor please, I have a stipulation in the case of Floyd J. Harkness, Petitioner, versus Commissioner of Internal Revenue, 16408. I would like to offer that in evidence. I have two copies here.

The Court: Is that applicable to both dockets?

Mr. Ehrlich: Yes. We happened to have drafted two separate stipulations.

The Court: The stipulation of fact will be received.

Mr. Ehrlich: I have that in the matter of Molly A. Harkness versus Commissioner of Internal Revenue, Docket No. 16407.

The Court: Are they identical?

Mr. Ehrlich: Yes, your Honor.

The Court: The stipulations of facts will be received.

You may proceed with your testimony. [25]

Mr. Ehrlich: Mr. Mather, I suggested to you this morning that we introduce in evidence the letter of deficiency and mark it 10-J.

Mr. Mather: There is no objection.

(Whereupon the document was marked for identification as Joint Exhibit 10-J.)

The Court: It isn't attached to the petition?

Mr. Ehrlich: It is attached, but I thought for purposes of writing the brief we could refer to it. We have two other exhibits.

Then, Mr. Mather, there is no objection to having Exhibit B in the petition, the partnership agreement of December 31, 1942, marked Exhibit 11-K?

Mr. Mather: No objection.

(Whereupon the document was marked for identification as Joint Exhibit 11-K.)

The Court: Admitted as Exhibit No. 11-K.

(Whereupon the document marked Joint Exhibit 11-K for identification was received.)



[Joint Exhibit 11-K is identical to Exhibit B attached to the Petition.]

Mr. Mather: That is also attached to the petition in each case.

Mr. Ehrlich: Then Exhibit C in the petition in each case is the supplementary agreement, January 3, 1943. That might be marked 12-L.

Mr. Mather: No objection. [26]

(Whereupon the document was marked for identification as Joint Exhibit 12-L.)

The Court: That may be admitted.

(Whereupon the document marked Joint Exhibit 12-L for identification was received.)

[Joint Exhibit 12-L is identical to Exhibit C attached to the Petition.]

The Court: Is one of those exhibits the notice of deficiency?

Mr. Ehrlich: Yes, Exhibit 10-J.

The Court: I don't think we got that straight in the record. Do you want to offer that?

Mr. Ehrlich: Yes, your Honor.

The Court: Exhibit 10-J is admitted.

(Whereupon the document marked Joint Exhibit 10-J for identification was received.)

[Joint Exhibit 10-J is identical to Exhibit A attached to the Petition.]

Mr. Ehrlich: 11-K is the partnership, December 31, '42; and 12-L is the supplementary agreement of



January 3, '43, all of which are part of the petition, your Honor.

Thank you.

Mr. Harkness, will you take the stand?

Whereupon

FLOYD J. HARKNESS

was called as a witness on behalf of the Petitioners, and having been first duly sworn, testified as follows:

The Clerk: State your name and address, please.

The Witness: Floyd J. Harkness, Fresno, California.

Direct Examination

By Mr. Ehrlich:

Q. You are the Petitioner in the case of Floyd J. Harkness versus the Commissioner? A. I am.

Q. And you reside in Fresno and have resided there all your life? A. I have.

Q. How old are you, Mr. Harkness. A. 56.

Q. Molly A. Harkness is your wife.

A. That is right.

Q. She is the Petitioner in the case of Molly A. Harkness versus the Commissioner of Internal Revenue? A. That's right.

Q. Were you and Mrs. Harkness married on July 14, 1915? A. We were.

Q. And you have resided in California continuously since? A. We have.

Q. You have two children, Floyd James Harkness and Harriet Harkness Colgate?

A. We have.

(Testimony of Floyd J. Harkness.)

Q. Have you any other children?

A. We have none.

Q. How old is your son, Floyd, Jr.? [28]

A. He was born in 1918.

Q. And your daughter?

A. Born in 1920.

Q. Your daughter is married to William Colgate?  
A. She is.

Q. When was she married?

A. In August, 1942.

Q. How long have you known your son-in-law?

A. Eight or nine years.

Q. Where does your son now reside?

A. In Sanger, Fresno County, California.

Q. Your son?

A. My son resides in the City of Fresno.

Q. And your daughter?

A. My daughter resides in Sanger, California.

Q. That is near Fresno?

A. Yes, that is 16 miles east of Fresno.

Q. What is your business or occupation?

A. Grower and shipper of fruits and vegetables.

Q. How long have you been engaged in this activity?  
A. Since 1918, including 1918.

Q. Mr. Harkness, will you briefly outline your farming activities and your activities as a buyer and seller of farm commodities just briefly so the Court may have the background? [29]

A. Well, we raise some commodities ourselves. We buy some commodities from the grower on a cash basis. We handle considerable tonnage on a

(Testimony of Floyd J. Harkness.)

commission basis for the grower's account. That applies to canteloupes, carrots, peaches, plums, nectarines, grapes, both table grapes and juice grapes.

Mr. Ehrlich: Mr. Mather, I assume it will be unnecessary to identify all these original contracts. They have all been in the stipulation so it will be unnecessary to show the handwriting.

Mr. Mather: They are all stipulated.

Q. (By Mr. Ehrlich): You are the Mr. Harkness who is mentioned in the partnership agreement which was signed by you, your wife, your son, and your daughter which was effective December 31, 1942; is that correct?

A. I am designated as Floyd J. Harkness in there. My son is designated as Floyd J. Harkness, Jr.

Q. And your daughter is designated as Harriet Harkness Colgate? A. That's right.

Q. And your wife as Molly?

A. Molly A. Harkness.

Q. Mr. Harkness, will you please relate to the Court just when you organized the first co-partnership in the fruit packing business? [30]

A. Well, the first co-partnership was organized in 1923. I had working arrangements with other fruit companies on a salary and bonus percentage basis prior to that date, but the actual filing of a certificate of doing business under fictitious title and operating as such was in 1923. There were three partners in that deal, H. H. Wilhelm of Di-



(Testimony of Floyd J. Harkness.)

nuba, California, Charles H. Jasper of Fresno, California, and myself.

That three-way partnership continued for a period of one year. Mr. Wilhelm didn't get along with Mr. Jasper and myself and saw fit to withdraw at the end of the first year.

Mr. Jasper and myself continued to operate as a partnership until the end of 1936. Mr. Jasper was some 18 years older than myself, and he was at that age in life when he was afraid to take chances. The fruit business had turned to where a man either had to take chances or just get out of the business.

We had very little capital. Our joint capital at the end of 1936 was slightly in excess of \$6,000 in cash. We owned two ranches together, a 160-acre vineyard and a 40-acre vineyard and orchard. We had packing houses at that time at Lodi, California; Clovis, California; Sanger, California; Exeter, California; Arvin, California.

In appraisal of our assets, neither one of us had sufficient money to buy out the other party, so it was a proposition of trading. The consummation of that trade was that I took over the packing houses and the picking boxes and equipment, etc., and Mr. Jasper took over the two ranches. Each one of us took half of the bank balance which we had, as I stated, approximately \$6,000. I took \$3,300, I believe it was, and he took an equal amount.

Q. When did you commence operating as a pro-



(Testimony of Floyd J. Harkness.)

prietorship under the name "United Packing Co." with yourself and your wife, approximately?

A. January, 1937.

Q. And you continued how long?

A. I continued to operate as a proprietorship or individual until December 31, 1942.

Q. What occurred on December 31, 1942?

A. I sold an interest in a part of my assets to my son Floyd J. Harkness, Jr., and Harriet Harkness Colgate, my daughter.

Q. At that time where were you operating prior to the consummation of the partnership?

A. Our main office was at Fresno, California.

Q. I will show you a map. Does this map indicate the scope of the activities which you were undertaking at that time?

A. It does. [32]

Q. Does it also show the commodities which you were engaged in buying and selling?

A. Yes, by districts.

Q. What was the relative distance that your activities comprehended?

A. Well, Arvin was 127 miles south of Fresno and Lodi was 138 miles north of Fresno.

Mr. Ehrlich: I ask that be introduced in evidence.

Mr. Mather: No objection.

The Court: Admitted as Petitioner's Exhibit 13.

(Whereupon the document marked Petitioner's Exhibit 13 for identification was received.)





## PETITIONER'S EXHIBIT NO. 13

(Admitted January 11, 1949.)

[Petitioner's Exhibit No. 13, a map of California, is in the custody of the Clerk of the Court of Appeals for the Ninth Circuit.]



(Testimony of Floyd J. Harkness.)

Q. (By Mr. Ehrlich): At the time that this partnership was created, you and your wife had certain community property, did you not?

A. We did.

Q. I am showing you a statement. To save time, might I explain this, Mr. Mather: I have prepared here a statement showing the assets and liabilities of United Packing Company, a co-partnership, as of the date 12/31/42; then the assets which were turned over to the partnership as of 1/1/43; then the personal property of Mr. and Mrs. Harkness.

I show you this document and ask you if I have correctly described it.

A. Yes, you have. [33]

Q. Was that prepared under your direction and control?

A. It was.

Q. It accurately reflects your books and records?

A. Yes, sir.

Mr. Ehrlich: I ask that that be marked Petitioners' next in order and offer it in evidence, as petitioners' next in order.

(Whereupon the document was marked for identification as Petitioners' Exhibit 14.)

Mr. Mather: No objection.

The Court: Admitted as Petitioners' Exhibit 14.

(Whereupon the document marked Petitioners' Exhibit 14 for identification was received.)

## PETITIONER'S EXHIBIT No. 14

Assets:	Assets & Liabilities United Packing Co. Proprietorship 12/31/42	Assets & Liabilities Co-Partnership 1/1/43	Assets & Liabilities Molly A. Harkness & F. J. Harkness Personal 1/1/43
Cash (On deposit Bank of America, Fresno Main Branch)	150,609.48	100,000.00	50,609.48
Paid up life insurance .....	1,901.24		1,901.24
U.S. War Bonds .....	1,875.00		1,875.00
Real Estate .....	18,287.60		18,287.60
Home Place (New 1939)			
40 Acres Selma .....	18,233.34		
Reserve for depreciation .....	982.87	17,250.47	17,250.47
90 Acres Selma .....	23,857.19		
Reserve for depreciation .....	1,792.71	22,064.48	22,064.48
Packing site (Parlier) .....		1,500.00	
Packing sheds Arvin, Clovis, Exeter, Lodi & Sanger .....	21,615.15		
Reserve for depreciation .....	15,966.41	5,648.74	5,648.74
Registered Brands .....	1,230.00	1,230.00	

Equipment			
Autos and Trucks .....	9,025.96		
Reserve for depreciation .....	2,925.58	6,100.38	6,100.38
Office .....	2,354.03		
Reserve for depreciation .....	1,293.03	1,061.00	1,061.00
Farm (including 3 tractors) .....	6,790.21		
Reserve for depreciation .....	2,895.07	3,895.14	2,689.85
Packing House .....	12,288.81		
Reserve for depreciation .....	8,976.86	3,311.95	3,311.95
Picking boxes .....		6,182.60	6,182.60
Packing materials .....		6,473.31	6,473.31
Japanese Picking Camps .....		428.77	428.77
Accounts Receivable .....		7,829.03	7,594.03
			235.00
Liabilities:			
Reserve for taxes, insurance, etc. ....		—3,959.02	—3,959.02
Unpaid balance Selma Ranch #1 .....		—7,350.00	—7,350.00
Unpaid balance Selma Ranch #2 .....		—8,327.18	—8,327.18
F. James Harkness, Jr. ....		—1,412.05	—1,392.05
Net Worth .....	234,600.94	138,241.61	96,359.33

Admitted January 11, 1949.

(Testimony of Floyd J. Harkness.)

Q. (By Mr. Ehrlich): On January 1, 1943, did the partnership now consisting of your wife and your son, your daughter and yourself continue in the same activity? A. We did.

Mr. Ehrlich: By the way, I have here the original certificate of co-partnership of transacting business under fictitious name, and I have made a copy. Is there any objection if I introduce in evidence, Mr. Mather, a copy of that?

Mr. Mather: No objection.

Mr. Ehrlich: I would like to introduce at this time the certificate of co-partnership of transacting business under [34] fictitious name.

(Whereupon the document was marked for identification as Petitioners' Exhibit 15.)

The Court: Is the original certified?

Mr. Ehrlich: It is notarized, yes, your Honor. I haven't had this certified.

The Court: That is all right. I thought you had a certificate from some official.

Mr. Ehrlich: Yes, we have a system in California when doing business under a fictitious name that you file this as a co-partnership, it has to be notarized before a notary public of California.

The Court: You can offer a copy. I understand there is no objection to the copy.

Mr. Ehrlich: I would also like to have it appear in evidence. I offer it in evidence as Petitioners' next in order.

The Court: Admitted as Petitioners' Exhibit 15.



(Testimony of Floyd J. Harkness.)

(Whereupon the document marked Petitioners' Exhibit 15 for identification was received.)

---

PETITIONERS' EXHIBIT No. 15

Certificate of Co-Partnership Transacting  
Business Under Fictitious Name

We, the undersigned, hereby certify that we are co-partners engaged in and carrying on a general business of growing, packing, shipping and the distribution of fresh fruits and vegetables in the State of California, under the firm name and style of "United Packing Co.":

That the principal place of said co-partnership is at 216 Rowell Building, Fresno, California.

That Floyd J. Harkness is the general manager of said company and in full charge of all of the business operations of said company.

That the names in full of all of said co-partners and their respective places of residence are as follows, to-wit:

Floyd J. Harkness, residing at 3767 Huntington Boulevard, Fresno, California.

Molly A. Harkness, residing at 3767 Huntington Boulevard, Fresno, California.

Floyd James Harkness, Jr., residing at 3767 Huntington Boulevard, Fresno, California.

Harriet Harkness Colgate, residing at 59 South Champion Street, Columbus, Ohio.

(Testimony of Floyd J. Harkness.)

In Witness Whereof, we have hereunto set our hands this 12th day of November, 1942.

FLOYD J. HARKNESS.

MOLLY A. HARKNESS.

FLOYD JAMES HARKNESS, JR.

HARRIET HARKNESS  
COLGATE.

State of California,  
County of Fresno—ss.

On this 12th day of November, 1942, before me, Julius Hansen, a Notary Public in and for said County and State, residing therein, duly commissioned and sworn, personally appeared, Floyd J. Harkness, Molly A. Harkness and Floyd James Harkness, Jr., known to me to be the persons described in, whose names are subscribed to and who executed the within instrument and acknowledged that they executed the same.

In Witness Whereof I have hereunto set my hand and affixed my official seal at my office in said County the day and year in this Certificate first above written.

JULIUS HANSEN,  
Notary Public in and for the County of Fresno,  
State of California.

(Testimony of Floyd J. Harkness.)

State of Ohio,

County of Franklin—ss.

On this 28th day of November, 1942, before me, N. R. Hall, a Notary Public in and for said County and State, residing therein, duly commissioned and sworn, personally appeared Harriet Harkness Colgate, known to me to be the person described in, whose name is subscribed to and who executed the within instrument and acknowledged that she executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal at my office in said County the day and year in this Certificate first above written.

N. R. HALL,

Notary Public in and for the County of Franklin,  
State of Ohio.

Admitted January 11, 1949.

---

Mr. Ehrlich: It appears that on this document I neglected to put the face on. If I may read into the record, it is dated November 12, 1942, recorded at the request of United Packing Company 10 minutes past 3:00 p.m., Volume 2054, Official Records P. Q. 478 et seq, February 4, 1943, Fresno, [35] County, California, I. E. Farley, County Recorder, by Deputy Recorder.

Q. (By Mr. Ehrlich): Mr. Harkness, at the

(Testimony of Floyd J. Harkness.)

time you sold the interest in the partnership to your children, did you receive promissory notes from them?       A. I did.

Q. I show you a document. Will you please explain what that is?

I might do it to save time. Is there any objection, Mr. Mather?

Mr. Mather: No objection.

Mr. Ehrlich: I have before me the original note which Floyd J. Harkness, Jr., gave to his father in the sum of \$33,168.36, dated January 2, 1943.

Q. (By Mr. Ehrlich): Is that the note that your son gave you?       A. It is.

Mr. Ehrlich: I ask that that be introduced in evidence.

(Whereupon the document was marked for identification as Petitioners' Exhibit 16.)

Mr. Mather: No objection.

The Court: That will be Petitioners' Exhibit 16.

(Whereupon the document marked Petitioners' Exhibit 16 for identification was received.)

[36]

---

## PETITIONERS' EXHIBIT No. 16

Fresno, California, January 2, 1943.

\$33,168.35

On demand, after date, for value received, I promise to pay to Floyd J. Harkness, or order, at Fresno, California, the sum of Thirty-Three Thou-



(Testimony of Floyd J. Harkness.)

sand, One Hundred Sixty-Eight and 35/100 Dollars, with interest from date hereof until paid, at the rate of 4 per cent per annum payable annually, also to pay a reasonable attorneys' fee and costs of suit in case suit is brought to compel payment hereof.

Should interest not be so paid it shall become part of the principal and thereafter bear like interest. Should default be made in payment of interest when due, the whole sum of principal and interest shall, at the option of the holder of this note become immediately due. Principal and interest payable in United States lawful money. This note is secured by my one-fourth interest in the United Packing Co. of Fresno, California.

FLOYD J. HARKNESS, JR.

Paid in full 12/31/43.

F. J. HARKNESS.

Admitted January 11, 1949.

---

Mr. Ehrlich: May I substitute a copy?

The Court: You may substitute a copy if there is no objection.

Mr. Ehrlich: Thank you, your Honor.

The Court: Do you have the ribbon copies of that for the record?

Mr. Ehrlich: Yes.

I have now in my hand a promissory note signed

(Testimony of Floyd J. Harkness.)

by Harriet Harkness Colgate and William H. Colgate, Jr., dated January 2, 1943, in the sum of \$34,560.40.

Q. (By Mr. Ehrlich): Is that the note that your daughter and son-in-law gave you and your wife in payment on the interest in the partnership?

A. It is.

Mr. Ehrlich: I ask that that be introduced as Petitioners' next in order.

(Whereupon the document was marked for identification as Petitioners' Exhibit 17.)

The Court: Admitted as Petitioners' Exhibit 17.

(Whereupon the document marked Petitioners' Exhibit 17 for identification was received.)

---

### PETITIONERS' EXHIBIT No, 17

Fresno, California, January 2, 1943

\$34,560.40

On demand, after date, for value received, I promise to pay to Floyd J. Harkness, or order, at Fresno, California, the sum of Thirty-Four Thousand, Five Hundred Sixty and 40/100 Dollars, with interest from date hereof until paid, at the rate of 4 per cent per annum payable annually, also to pay a reasonable attorney's fee and costs of suit in case suit is brought to compel payment hereof.

Should interest not be so paid it shall become part of the principal and thereafter bear like in-

(Testimony of Floyd J. Harkness.)

terest. Should default be made in payment of interest when due, the whole sum of principal and interest shall, at the option of the holder of this note become immediately due. Principal and interest payable in United States lawful money. This note is secured by my one-fourth interest in the United Packing Co. of Fresno, California.

HARRIET HARKNESS  
COLGATE.

WILLIAM H. COLGATE, JR.

Paid in full 12/31/43.

F. J. HARKNESS.

Admitted January 11, 1949.

---

Mr. Ehrlich: And may I be permitted to substitute a copy?

The Court: You may substitute a copy for the original. [37]

Mr. Ehrlich: For your Honor's information, there appears on the face of the note "Paid in full 12/31/43, Floyd J. Harkness," on both notes.

The Court: Does that appear on the copies also?

Mr. Ehrlich: Yes, that is on the copy, your Honor. Thank you.

In order to expedite matters, I have in my hand a statement, a sheet of paper which is the income of Floyd J. Harkness and Molly A. Harkness from

(Testimony of Floyd J. Harkness.)

community property not included in capital and assets of United Packing Company, a co-partnership, for the years 1943 to '47. It shows what individual incomes they had other than what was turned over to the partnership.

Q. (By Mr. Ehrlich): Was that prepared from the books and records of the corporation, showing you this document? A. It was.

Mr. Ehrlich: I would like to introduce this in evidence, if your Honor please.

(Whereupon the document was marked for identification as Petitioners' Exhibit 18.)

Mr. Mather: If your Honor please, I have no objection to the document except for the years not involving our taxable year, which are '44, '45, '46, and '47. I will object to that as immaterial. I have no objection to '43. [38]

The Court: Are you confining it to '43 then?

Mr. Ehrlich: Let me first ask that—may I read into the record, I make this offer in two parts. The books and records of Floyd J. Harkness and Molly A. Harkness indicate that their income from community property not included in the capital assets of United Packing Company, a co-partnership, for the year 1943, was \$11,426.76.

Mr. Mather: I have no objection to that.

Mr. Ehrlich: I make the offer of the other years, 1944, '45, '46, and '47.

The Court: What is the purpose of the additional offer?



(Testimony of Floyd J. Harkness.)

Mr. Ehrlich: Merely to show that during the years there were no gifts made and that the father and mother retained these other properties, and that they did not at any subsequent date turn over to the family property, to show the atmosphere and surrounding circumstances and bona fides as bearing on our theory.

The Court: That wouldn't show that, would it?

Mr. Ehrlich: I thought it was relevant testimony.

The Court: It just shows they had certain income aside from that received through the partnership.

Mr. Ehrlich: That is correct, your Honor.

Mr. Mather: I might explain my objection a little further. I understand that the subsequent years are pending [39] before the Bureau, and I haven't checked these figures for subsequent years and I wouldn't want them in the record without objection. I don't dispute that your books show that.

Mr. Ehrlich: We have them here if there is any question about it.

The Court: I will overrule the objection. It may be admitted as Petitioners' Exhibit 18.

(Whereupon the document marked Petitioners' Exhibit 18 for identification was received.)

(Testimony of Floyd J. Harkness.)

# PETITIONERS' EXHIBIT No. 18

Income of Floyd J. Harkness and Molly A. Harkness From Community Property Not Included in Capital and Assets of United Packing Co., a Co-Partnership

Year	
1943	\$11,426.76
1944	18,347.22
1945	4,492.07
1946	47,862.32
1947	12,960.60

Admitted January 11, 1949.

Q. (By Mr. Ehrlich): Mr. Harkness, when did your son first start working for you? I am not talking about the partnership now of January 1, '43, but when did he first start working for you?

A. His first activity in the fruit business was during the period of my partnership with Mr. Jasper.

Q. How old was he at that time, about?

A. Well, I don't recall the exact year that he started, but I do know that he worked on Mr. Jasper's and my ranches as well as worked in the packing houses on various occasions, summer vacations. Usually in California the school vacation is the busiest part of the packing season, June, July, and August.

(Testimony of Floyd J. Harkness.)

Q. That is the height of the season?

A. That's right.

Q. And he worked off and on when you and Mr. Jasper were [40] partners from 1924 to '37 or thereabouts?

A. No, not as far back as 1924. I would judge that he was of high school age when he first started.

Q. Did he at any time definitely work for you after you severed your relations with Mr. Jasper?

A. He did. He worked, continued to work, and he ran several districts for me.

Q. When was that? When did he actively identify himself with your activities? A. 1937.

Q. Will you please explain that to the Court?

A. I partially explained that before, Mr. Ehrlich, but as I stated, Mr. Jasper and I divided up. I took the operation end of the partnership and some \$3,300 in cash. Frankly, I didn't have the money to operate the packing houses I had taken in trade, and I wasn't too good a risk for the banks at that time, so I had to skimp by. My son stayed out of college the whole fall of 1937, which is the shipping season of our business, and devoted his entire time to the activity of the United Packing Company. He resumed his college attendance in February of 1938 and continued on until the summer vacation of 1938, when he again worked for me.

Q. Did he work for you in the summer of '39?

A. He did.

Q. '40? [41] A. He did.

Q. When did he graduate from college?

(Testimony of Floyd J. Harkness.)

# PETITIONERS' EXHIBIT No. 18

Income of Floyd J. Harkness and Molly A. Harkness From Community Property Not Included in Capital and Assets of United Packing Co., a Co-Partnership

Year	
1943	\$11,426.76
1944	18,347.22
1945	4,492.07
1946	47,862.32
1947	12,960.60

Admitted January 11, 1949.

Q. (By Mr. Ehrlich): Mr. Harkness, when did your son first start working for you? I am not talking about the partnership now of January 1, '43, but when did he first start working for you?

A. His first activity in the fruit business was during the period of my partnership with Mr. Jasper.

Q. How old was he at that time, about?

A. Well, I don't recall the exact year that he started, but I do know that he worked on Mr. Jasper's and my ranches as well as worked in the packing houses on various occasions, summer vacations. Usually in California the school vacation is the busiest part of the packing season, June, July, and August.



(Testimony of Floyd J. Harkness.)

Q. That is the height of the season?

A. That's right.

Q. And he worked off and on when you and Mr. Jasper were [40] partners from 1924 to '37 or thereabouts?

A. No, not as far back as 1924. I would judge that he was of high school age when he first started.

Q. Did he at any time definitely work for you after you severed your relations with Mr. Jasper?

A. He did. He worked, continued to work, and he ran several districts for me.

Q. When was that? When did he actively identify himself with your activities? A. 1937.

Q. Will you please explain that to the Court?

A. I partially explained that before, Mr. Ehrlich, but as I stated, Mr. Jasper and I divided up. I took the operation end of the partnership and some \$3,300 in cash. Frankly, I didn't have the money to operate the packing houses I had taken in trade, and I wasn't too good a risk for the banks at that time, so I had to skimp by. My son stayed out of college the whole fall of 1937, which is the shipping season of our business, and devoted his entire time to the activity of the United Packing Company. He resumed his college attendance in February of 1938 and continued on until the summer vacation of 1938, when he again worked for me.

Q. Did he work for you in the summer of '39?

A. He did.

Q. '40? [41] A. He did.

Q. When did he graduate from college?

(Testimony of Floyd J. Harkness.)

A. June in 1941.

Q. What did he do when he graduated from college?

A. He immediately went to work for United Packing Company.

Q. When you say "United Packing" you mean the business conducted——

A. By Mrs. Harkness and myself.

Q. United Packing Company proprietorship. What compensation did you pay him for his services during '41?

A. 1941 he got the regular field man's wages of \$150 a month, and while I had one field man that was getting 25 per cent of the net profits I reasoned with my son that I couldn't afford to pay him any such percentage, there would be nothing left for myself. So we settled on a basis of five per cent.

Q. So during '41 your son got the regular field man's salary and five per cent of the profits?

A. Yes. I might add he wanted at that time to become interested in the business, but I explained to him that there were so many already associated in the business on a high percentage basis that I couldn't take him in at that time, but I would give him a definite promise that I would make room for him before the 1942 season rolled around.

Q. By the way, would you explain to the Court the quality [42] of personnel that is required for an operation such as you have so the Court will

(Testimony of Floyd J. Harkness.)

understand the bonus and percentage deals that you had as shown in the stipulation?

A. Well, the fruit business is highly specialized. All the commodities we handle are perishable in nature. Their value is determined by the edibility, the eating quality; their price is also predicated on their general appearance. Our shipments of our commodities are to the 48 states of the Union. Prior to the war we exported principally grapes to the South Pacific, Australia, India, to Europe, and a person really had to know quality from the consuming public's viewpoint, and he had to know grapes and fruit—we handled a lot of peaches and nectarines that would carry by freight, which is from five to eleven days in transit, and arrive at destination in a satisfactory condition to enable us to get a reasonable price for the fruit.

The Court: Do you refrigerate your cars?

The Witness: Yes, sir. Some of our shipments are by Railway Express in refrigerated cars. Mostly they are in railroad freight cars, refrigerated cars.

Mr. Ehrlich: If your Honor please, I will take the time of the Court at this time, and without taking Mr. Harkness' time, your Honor, we have attached to the stipulation a list of the bonuses paid and percentages paid to various employees.

The Court: It is in the stipulation? [43]

Mr. Ehrlich: In the stipulation. There is a great deal covered in the stipulation, your Honor, so it may appear that we have gaps here, but I think when your Honor examines the stipulation you will



(Testimony of Floyd J. Harkness.)

find a great deal of the matter is covered by the stipulation here. I just wanted to explain that.

Q. (By Mr. Ehrlich): How long did your son continue working for you during '41, all year '41?

A. From June—well, he graduated, I think, on a Thursday, and went to work on Friday. We were actually shipping plums on the day he graduated, so it was necessary for him to go to work at once.

Q. And he continued with you until when?

A. Until he enlisted in the Army, shortly after Pearl Harbor.

Q. At the time he enlisted in the Army he had a draft deferment as essential?

A. Yes, he had received two deferments, one to complete his college education, and then immediately they gave him an exemption on account of his agricultural activities.

Q. Isn't it a fact that just prior to Pearl Harbor he had received another deferment because of his activities with your business?

A. I think that is so.

Q. And that he waived that deferment and enlisted in [44] January of '41?

A. January, '42, he enlisted.

Q. Excuse me, January, '42? A. Yes.

Q. When did he return to Fresno?

A. The first week of January, 1946. I don't know whether it was the 4th or 5th.

Q. And he has continued working for you since his return from the Army, is that correct?



(Testimony of Floyd J. Harkness.)

A. He has.

Q. Now, with reference to your son-in-law—by the way, your son-in-law enlisted in the service, didn't he?

A. He volunteered to go with the very first contingent of draftees that left Fresno, with this thought in mind—this he told me, so it is not hearsay: the draftees were expected to serve one year; that was before Pearl Harbor, military training of one year, and he was anxious to serve his one year and get out and get into business for himself.

Q. When did he return from the service?

A. About the 1st of October, 1944.

Q. When did he commence working for you?

A. Within the next two or three days.

Q. And he has been working for you ever since?

A. Yes, sir, continuously.

Q. And he became a member of the partnership as appears [45] from the contracts on January 1, 1945, is that correct?

A. He was permitted to become an active participant in the partnership.

The Court: Let's see, did he and his wife, Petitioner's daughter, split the 25 per cent interest that she had previously?

The Witness: Yes, sir, that's right.

Mr. Ehrlich: That appears under one of the exhibits in the case, your Honor, the supplemental agreement to the partnership dated January 16, 1945.

(Testimony of Floyd J. Harkness.)

The Court: All right.

Q. (By Mr. Ehrlich): Will you please relate the conversation had with your son with respect to the formation of the partnership of January 1, 1943?

A. Well, at the time that I made the arrangements with him for 1941, that is, just after he got out of college, he wanted at that time to become a partner, and as I explained to him, I was already burdened with a Mr. Steiger who was getting 25 per cent of my profits, Mr. Sorensen who was getting 25 per cent of my profits, Mr. Scoggins who was getting a salary and 10 per cent, and I think I had two or three others on a salary and bonus basis, so that I just couldn't afford, with the load already contracted for, high percentage men, to take on any further obligation; but I would go along with him on a salary plus five per cent basis in 1941. He accepted that with reluctance, but I promised him that I would somehow change my affairs so that he could become a partner before the 1942 season rolled around.

Q. Continue then, what occurred during 1942?

The Court: You used that word "Partner." You mean in the sense of participating in the profits, or a real technical partnership?

The Witness: With my son?

The Court: Yes.

The Witness: I was going to take him in as a partner. That had been discussed ever since he was of high school age.

(Testimony of Floyd J. Harkness.)

With the other parties operating with me on high percentage basis, I had to guarantee them not only a salary of a minimum amount they would earn, but I had two cases where I gave them 25 per cent of the net profits of the business.

The Court: That was their compensation; it was your business, they were not partners?

The Witness: That's right. In the case of Mr. Sorensen where we financed the purchase of a ranch, 50 per cent interest to an employee to hold him in the business, that was a true partnership; he had an undivided one-half interest in a 300-acre vineyard and orchard. [47]

The Court: That was outside of this partnership we have before us?

The Witness: No, that is tied in with this partnership.

Q. (By Mr. Ehrlich): Continue the conversations with your son regarding the formation of the partnership.

A. Well, as everyone knows, December 7, 1941, the Pearl Harbor incident occurred. Congress immediately declared war. At that time there was so much going on my son said, "Let's forget the business for the minute. I am going to enlist."

He was anxious to get into the Air Corps, and he enlisted and went with a contingent from Fresno about the middle of January, 1942, to Shepherd Field, Texas. But for the year 1942 he was stationed first in one place, then in another, and continuously in his letters to me he wanted to know



(Testimony of Floyd J. Harkness.)

whether it couldn't be arranged. He had been told that we were allowed to continue payment of his wages by the Wage Stabilization Board, and he saw no reason why we couldn't go ahead with our original partnership arrangement.

During that time he was stationed in Texas and Colorado and Presque Isle, Maine, and he went to Officers Training School at Miami, Florida, was commissioned a lieutenant in October of 1942. [48]

He stopped off in Fresno en route under orders to Hamilton Field, Marin County, California, and at that time with legal advice, as I have stated, we formed the partnership, when he was traveling under orders, and stopped over in Fresno.

For a period after the partnership was formed, he was stationed at Hamilton Field until the 22nd or 23rd of December, 1943, when he was flown to India. During that period of a year that he was stationed at Hamilton Field, he was home practically every other week-end, and we carried on the business there with him nearby and correspondence with my daughter and son-in-law who were stationed in Columbus, Ohio, most of the time, part of the time at Camp Lee, Virginia.

Q. It was during the fall, then, of '42 that these discussions occurred with your son with reference to the formation of the partnership, and the partnership was formed prior to his leaving for India?

A. Yes, sir. The actual formation of the partnership was while he was stationed at Hamilton Field, California.



(Testimony of Floyd J. Harkness.)

Q. You had some discussions with your daughter, did you not, and your son-in-law, respecting the formation of this partnership? A. Well——

Q. You can answer that “Yes” or “No.”

A. Yes. [49]

Q. Will you please describe to the Court the period during which these conversations occurred and what these conversations were regarding the formation of the partnership?

A. When my daughter learned in 1941, while she was still attending college—she came home practically every other week-end from Los Angeles; she attended the University of Southern California—she learned that I had promised to sell my son an interest in the business, and immediately she put in a bid for something for herself. We discussed all angles of it, pro and con, and she was then expecting to marry Mr. Colgate, whether she thought they could get along with the old folks and Jim in a partnership.

Q. Who is “Jim”?

A. “Jim” is Floyd James Harkness, Jr. I suggested to her perhaps that if I was going to help her get established in life, loan her some money, it would be better for her to buy some of the di Giorgio Fruit Company stock which then was very low.

After a lot of consideration and the event of war before the partnership was actually consummated—she traveled all over the East with her husband from one Army camp to another. He was then at

(Testimony of Floyd J. Harkness.)

the time of their marriage a lieutenant, became a captain, a graduate of the Staff and Command School at Fort Leavenworth, Kansas—they decided that rather than investing with an outside interest that they would be safer to invest [50] in the United Packing Company which she had been familiar with from the time she was able to understand what people were talking about.

Q. You had legal counsel draft the partnership agreement which has been introduced in evidence here? A. Yes, sir.

Q. When I say “partnership agreement” I am talking of the original January 1, 1943, document.

A. Attorney Julius Hansen.

Q. Your daughter was then located in Ohio with her husband at some training camp there?

A. Yes, Columbus, Ohio.

Q. Did you send the document on for signature?

A. I did.

Q. Was it signed?

A. No, it was sent back.

Q. Unsigned? A. Yes, by her.

Q. Your daughter did not sign the document at the time?

A. No, not the original document.

Q. The original you sent back? A. Yes.

Q. And she sent it back to you?

A. Yes, sir.

Q. Did you send any other documents on or did you go [51] yourself to Columbus, Ohio?

A. No. Several letters were exchanged, and in

(Testimony of Floyd J. Harkness.)

January, 1943, I attended the United Fresh Fruit and Vegetable Association in Chicago with Mrs. Harkness accompanying me. We went down to Columbus after the completion of the convention and discussed the situation with her.

Q. Did she refuse to sign? Did she tell you why she refused to sign?

A. She thought inasmuch as her husband was going to participate in there, she didn't think I should have so much to say about the management of it.

Q. As a result of the discussions—did your son participate in those discussions as well, or not?

A. He was in California and participated in them, yes.

Q. As a result of your discussions with your daughter, did you change the form of the partnership agreement?      A. We did.

Q. Were they then sent on to your daughter for signature?      A. Yes, they were.

Q. And your daughter ultimately signed?

A. I think it was in March of 1943.

Q. But she did require before she signed that the provisions respecting your rights of management be modified?      A. That's right. [52]

Q. Now, Mr. Harkness, there is attached to the stipulation here certain exhibits, 4-D and 5-E.

If your Honor please, these exhibits show the participation of Mr. Sorensen and the various bonuses and percentage deals, just so that your



(Testimony of Floyd J. Harkness.)

Honor may be familiar to understand the next question I am asking. As a matter of interest to your Honor, Mr. Sorensen, one of the men Mr. Harkness testified helped him to run the company, received in '43, '44, '45, and '46 from this ranch which Mr. Harkness voluntarily paid for and gave him a half interest in, taking his note for it, he received in profits from that operation \$144,310.26, and then forced the Harknesses to buy that back. The partnership bought it back and he made a capital gain of \$42,354.70, which is all part of the compensation Mr. Harkness had to pay Sorensen for his services to the partnership. It shows without going into detail these other payments over this entire period of time since Mr. and Mrs. Harkness organized and ran this proprietorship right to the present time, continuing to where the children participated.

Now, Mr. Harkness, I would like to ask you what effect, if any, did the percentage and bonus deals which I have just called to your attention, have on your business?

A. Well, they drained the capital. Even though the figures show that the United Packing Company had made nice profits, sizeable profits, prior to the war, and even during [53] the first part of the war there—no, the partnership was formed just at the outbreak of the war—the treasury or the funds left to operate the succeeding season was really very small compared with the profits I made due to the fact that it paid Steiger 25 per cent and Sorensen 25 per cent and 50 per cent of a ranch that we



(Testimony of Floyd J. Harkness.)

financed him with, so there was just nothing left for the business, it couldn't enlarge. Had they had one bad operating year they would have become insolvent.

In that respect I want to say that it is not uncommon in the fruit business. My first venture was with the Setchel Fruit Company in 1918, '19 and '20. That was during the period of the first World War. Mr. Setchel went into bankruptcy.

I worked with the Associated Fruit Company, ran their entire shipping operations in the State of California. They had other operations, you know, in Wenatchee and Yakima and Florida; however, I was just connected with the California operations. I got out of there just before they went bankrupt.

And we had competitors. E. Y. Foley Company went broke just after World War I. H. V. Rudy, the Fresno Fruit Growers, went broke. The old-time commission houses, Producers Fruit Company, the Pioneer Fruit Company, with headquarters in San Francisco and Sacramento, and Stewart Fruit Company, with headquarters in Sacramento, went broke during that period, all because they didn't have the funds to keep afloat, and the risks that they took during the war period.

Q. Isn't it also true that these men after they left your employ became competitors of yours, made it more difficult for you to engage in business, you trained most of these men who received these bonuses?

A. Yes, I did. Mr. Sorensen was a tenant

(Testimony of Floyd J. Harkness.)

farmer when I first employed him under the Jasper-Harkness period as a field man, and he made good.

Another case is Mr. E. L. Barr, Sanger, California. He served under the Jasper and Harkness period. He has been a very successful competitor of mine and perhaps made considerable more money than I have. He has been in business for himself for the past 15 years or 12 years.

Q. Will you explain to the Court where the need for capital exists in the business?

A. Well, the first need of capital, if you weren't a rancher at all, would be to take care of the growers' financial needs. We have been through a lot of periods when the grower couldn't get his finances from the bank, and competition from the fruit business from these so-called large fruit companies has made loans readily available to these growers that are a shaky risk, and as long as I was in competition with them I either must pass up that desirable tonnage to be [55] secured from the farmers or I must arrange to finance it. And I must contract for the purchase of boxing materials, nails, prior to the commencement of the season. Some years there is a shortage of box shook and we start taking it in January. The value of box lumber has gone up from \$800 or \$900 in pre-war days to \$3,000, \$3,500 a car now. Nails that we used to pay \$2.50 a keg for are now \$11 and \$12 a keg. All our supplies have raised in proportion, so our need for capital is more apparent in the last few years than it was in the old days.

(Testimony of Floyd J. Harkness.)

We are in the ranching deal now quite heavily as a partnership because there are certain varieties of grapes that were necessary, and tree fruit to round out our commercial pack. True, we could go out and get one or two or a dozen growers' crops of Thompson Seedless, for instance, white seedless variety, very popular; but the trend of affairs has been that my competitors have been able to supply red grapes in mixed cars, that is, half a car of red grapes and half a car of white grapes, and they were getting all the business. There wasn't sufficient supply of Red Malaga grapes available to purchase, let alone secure on commission; so in the past four or five years we have planted a considerable acreage of Red Malaga grapes to enable us to round out our otherwise commercial pack of Thompson Seedless.

One of the prime motives in buying the so-called River Ranch in conjunction with Sorensen was without that particular plum crop we did not have enough plums available in the Sanger area to even open our shed and round out a plant. True, we might have had 10 cars of plums to ship over a two weeks, three weeks period, but any man experienced in the fruit business knows that you must have a reasonable volume of perishable commodity like that so that the plums are picked today, the car will be started on its way to New York or someplace else and not held there two or three days waiting for more plums to get ripe.

Q. Did you discuss with your children the neces-



(Testimony of Floyd J. Harkness.)

sity for keeping the capital in the business, the profits?      A. Yes, sir, I did.

Q. Would you please state what you said to them?

A. Well, I can't tell you in exact words.

Q. I mean substantially, the substance.

A. The substance was——

Q. This is prior to the formation of the partnership, is that correct?      A. Yes, sir.

Q. Will you please state the substance of your discussions with your children?

A. Well, many times they have wanted things that I wasn't able to give them, wanted this and that, and they full well understood what the nature of my business was and where [57] the profits were going—to Steiger and Sorensen and Scoggins and other people that were operating not only on a guaranteed salary but high bonuses.

Q. Did you tell them what your idea was as to the actual distribution of profits in the partnership before you organized it?

A. I very definitely told them that if we were going to make a success of the fruit business that all we could expect would be to take a reasonable salary out and leave the balance of the earnings if there was any earnings in there for expansion and development of new business.

Q. Did they agree to your theory of conducting the partnership?      A. They did.

Q. As far as participation in profits were concerned?      A. They did.



(Testimony of Floyd J. Harkness.)

Q. And distribution, I mean. A. Yes.

Q. Am I correct when I state that this was one of the reasons which motivated you in forming this partnership? A. It was.

Q. Mr. Harkness, will you please explain to the Court the conditions surrounding your activity during the year, during the summer and end of '42, the prospects of your business, of the activity? [58]

A. Well, that was the first year of the war. The Japanese submarines were reported off the Coast of California, shooting them down in Santa Barbara County, destroying reserve oil stocks, tanks.

We use a great deal of Japanese labor in our farm operations, harvesting operations. They owned quite a few ranches in California. We did business with a lot of Japanese who owned their own ranches and sold their crops to us, turned them over to us on commission basis. They were being rounded up and sent to concentration camps in Arizona, Utah, Tule Lake, California.

The Department of Agriculture had issued priority lists of what commodities we could have their assistance on with the War Production Board and in procurement of nails. Their prime crops, of course, were essential, such as potatoes, onions, carrots, and the like; and canteloupes which we were handling, and some six or seven hundred carloads of grapes, 400 carloads of peaches, nectarines, were way down the list. We had no reason to expect that we would be allowed to ship but a very small portion, if any, of those crops.

(Testimony of Floyd J. Harkness.)

I did feel, however, there might be a chance to make a profit because ranch properties in World War I advanced in value. We had no OPA in World War I, and we were confronted with an OPA regulation on all our commodities in 1942—it actually became effective in 1943. We had restrictions on [59] gasoline, and inasmuch as we operated throughout the valley we had to transport crews from places like Sanger, a city of around 3,500 population, out to the surrounding country to work on the ranches. Prior to the war, when gasoline was available and tires were available, new cars were available, they transported themselves. Immediately when gasoline and tires were rationed, we had to furnish transportation for all the help.

Wages were frozen on all our help. The shipyards in San Francisco Bay Area, the airplane factories in Los Angeles, were taking all our best help down there. They could get considerable more money. The classification for an employee in a shipbuilding plant wage scale was considerably above the wage scale for packing house labor, he could get approximately three times as much. The same way in an airplane factory.

I could go on and on with the hazards that were ahead of us. We had the raisin order. We owned Thompson Seedless vineyard, we had bought the vineyard primarily as a source of shipping table grapes. The raisin industry has been since its inception in 1913 an unprofitable deal, they have had one organization after another, Sun Maid

(Testimony of Floyd J. Harkness.)

Raisin Growers sign up this and sign up that; they are now even petitioning the Department of Agriculture for a marketing agreement, they are in terrible straits. [60]

During World War I I went through that in the fruit business. Congress passed the 18th Amendment which dried up the country. Wine grapes were of no value. I had no way of knowing but what some such restriction might occur in this world war.

As it turned out, the very reverse happened. The War Materials Board, I believe it is, one of the government agencies, put a stop order on the use of grain for the manufacture of hard liquor. That occurred early in '43, and wine—I am Director of one of the cooperative wineries down in the Valley, so I know whereof I speak—wine prior to that time was selling for 40c a gallon, and when this order prohibiting the use of grain became effective, not only did the price of wine skyrocket to \$1.40, \$1.50, \$1.60 a gallon, from 40c to \$1.60 a gallon, but the eastern distillers whose operations were tied up at that time by that non-use of grain order came to California and bought up wineries. They paid fabulous prices for them. Seagram's came to California, National Distillers, Schenley. They are all still in business here.

The net result of the stoppage of the use of grain there meant that we got an increase in the price of grapes from \$20 a ton up to as high as \$140 a ton. I am sure that I couldn't foresee what the govern-



(Testimony of Floyd J. Harkness.)

ment might do as far as the outlooks for the use of grain or grapes was concerned. [61]

Q. As I take it, you did not form this partnership in anticipation of large profits?

A. No, sir, very much to the contrary. I expected that we were going to make less profit in '43 than we did in '42.

Mr. Ehrlich: If your Honor please, could I have a couple of minutes?

The Court: We will take a recess of about 10 minutes.

(Short recess.)

The Court: You may proceed.

Q. (By Mr. Ehrlich): Mr. Harkness, in addition to accumulation of profits, permitting the profits to accumulate in the business, did you have any other reasons for forming the partnership?

A. Well, very definitely, Mr. Ehrlich. I have recited here of the key men, I have recited of the knowledge that men must have of the perishable commodities, not only sales appeal but carrying quality, and I knew that my son had the qualifications. I wanted to assure him for the future and assure the United Packing Company of a competent employee, a man to take charge of the outlying districts, districts separated some 270 miles north and south and about 75 miles east and west.

Many times all the sheds or packing houses are operating at the same time. I must spend a portion of my time in [62] the office, and there must be



(Testimony of Floyd J. Harkness.)

somebody with the interest of the business at heart to supervise the operations in each district, at least once a day. In several big partnerships of brothers, notably Arena Company in Los Angeles, there are six brothers, and one of them is in each shed. Every time they operate there is one of the brothers present. They go into their operations to that extent.

Mr. Colgate, as I said, I had known him for eight or nine years, he had worked for the Peerless Pump Company, a subsidiary of the Food Machinery Corporation. Among their other activities they were the largest suppliers of irrigation pumps in the San Joaquin Valley. They had to be able to figure irrigation programs for the farmers, the amount of water that would be required, the amount that could be obtained from a certain well, in order to take care of the enterprise that they were supposed to supply water for. Mr. Colgate had majored in commerce while in college, he had signified his desire to get into the agricultural field for his life's profession. He had an uncle who is the managing partner of the Rapid Harvest Company who operate in Salinas District in lettuce and carrots, Imperial Valley, Arizona. Their business is to furnish trailers and tractors and trucks to move the crops of various shippers and growers from the field in which they are produced to the packing sheds, and his uncle, Mr. Brewer, was in much the same fix that I was, in need of men [63] on whom he could depend and weren't just floaters looking for a stake, one

(Testimony of Floyd J. Harkness.)

year's operation, getting a bonus. Mr. Brewer of the Rapid Harvest Company was very anxious to get his services as soon as he got out of the Army.

As I said before, I promised my daughter when I had agreed to take my son into the business that I would finance her in some investment, and she turned down other possible places to invest her money and decided to invest in the United Packing Company, understanding that when her husband was released from Army service that he would be allowed to participate in the partnership interest in the United Packing Company.

Q. You knew at the time you organized the company both your son and son-in-law were in the service, and you knew, naturally, that they couldn't render any service at the time. Why did you create the partnership knowing that they could not render any service until they were released from the Army?

A. I wanted to be sure of their services. My son was emphatic in his wants, and he knew my set-up of giving large bonuses. I had declined to take him in in 1941 because I was overloaded, so to speak, with percentage deals with other strangers, and he thought perhaps with the war on that I might find myself in a position where I would have to take some of these so-called percentage or bonus deals on for a term of years and that when he came back he might be confronted with the same story that he was confronted with, and I would be confronted [64] with the same situation that I was in 1941.

(Testimony of Floyd J. Harkness.)

Q. Mr. Harkness, I direct your attention to the supplemental agreement dated January 4, 1943, which fixes your salary at 75 per cent of the first \$100,000 and then allocates the profits. How was that compensation arrived at?

A. By a thorough discussion with the new partners. That is covered in the articles. It said that for the time being that I would be the only active participant, and that as soon as the other parties thereto were in position to give their services, that they would be provided for the same as I had been, with a salary.

Q. And that same procedure was followed in '45 when Colgate returned from the service?

A. It was.

Q. And as the stipulation in evidence shows, in '46 you drafted an agreement where the salaries of your son and son-in-law and yourself were again fixed.

A. That's right.

Q. And that same procedure was followed in '47?

A. That's right.

Q. With the salaries being fixed as a result of getting together, and the agreements incorporating the salaries are in evidence.

Now, in all these agreements they are based on a percentage of the profits of the United Packing Company, is that [65] correct?

A. That is correct.

Q. Mr. Harkness, did you, prior to the creation of the January 1, 1943, United Packing Company



(Testimony of Floyd J. Harkness.)

partnership, discuss tax savings which might result from the formation of the partnership?

A. They might have been discussed, but they weren't the primary motive.

Q. I am asking if you discussed it?

A. I did.

Q. Did you discuss them with counsel?

A. With counsel, yes, sir.

Q. Did you discuss them with the children?

A. I did not.

Q. Did the consideration of tax savings—what place did that play in the formation of the partnership?

A. Will you repeat the question, please?

Q. What consideration did you give to tax savings in the formation of the partnership?

A. I gave this consideration: After consulting with Counsel I stated that it was my purpose to do something for my daughter and to help her and her husband get started in life. I didn't propose to give them anything, I don't believe in giving children anything; I believe in giving them nothing but the opportunity to make good. I had promised my son that I would [66] sell him an interest in the business.

Counsel in the discussion pointed out that perhaps the daughter would be better satisfied with an outside investment. My answer to him was that that wouldn't accomplish my purpose of getting another competent and reliable man to help share the burdens of the United Packing Company. If



(Testimony of Floyd J. Harkness.)

they were financed in some other field I would still find myself in the same position of having to secure competent help on the salary-bonus proposition.

For that reason I considered only one angle, and regardless of what the tax consequences might have been, whether there had been no taxes at all, I would have made the same deal that I made.

Q. Then, as I understand your testimony, you did not discuss this tax phase with your children?

A. In generalities. I never pointed out where there would be any tax saving for me, no. They might have got it out of various things I have said, but I never sat down and figured, "Now, if we do this I will save this; and if I do that I will save that."

It was my full intent to get Mr. Colgate and my son into the business with me.

Q. For the reasons which you have testified to several times?

A. Yes, sir. [67]

Mr. Ehrlich: That is all.

The Court: Cross-examine.

### Cross-Examination

By Mr. Mather:

Q. Will you explain to the Court, Mr. Harkness, what new capital came into the business by the agreement of December 31, 1942, Exhibit 11-K?

A. At the end of 1943, I believe that the capital accounts will speak for themselves, that there was considerable more capital in the business than there was at the end of 1942.

(Testimony of Floyd J. Harkness.)

Q. I am talking about 1942 when this agreement was entered into. What new capital came into the business by the agreement of December 31, 1942?

A. I made a loan to my son and to my daughter and son-in-law, Mr. Colgate. Mr. Colgate is a son of the Colgate-Palmolive-Peet family. His father is very able to have signed that note with him or loaned him the money had I needed that additional fund right at that moment.

Q. That is not my question. Did any new capital come into the business, United Packing Company, by the agreement of December 31, 1942?

A. Not except \$1,000 or \$1,500 that my son had to his credit on the books.

Q. That is the only new capital. You owed your son for services performed for prior years a balance of some \$1,300. [68]

A. Or whatever it was, in that neighborhood, yes.

Q. And the partnership agreement provided that these notes were to be paid out of the earnings of the business, didn't they? A. Yes.

Q. Now, I understand your testimony to be that you created United Packing Company in 1937?

A. No, the United Packing Company was created in 1923 by Mr. Jasper and myself and Mr. Wilhelm. The three of us originated it in 1923. Mr. Wilhelm withdrew at the end of 1923. From 1924 to 1936 Mr. Jasper and I operated under the name of United Packing Company.

Q. Then you became a sole owner in 1937, is that it? A. That's right.

(Testimony of Floyd J. Harkness.)

Q. And operated as a sole proprietorship?

A. That's right.

Q. When you talk of Mrs. Harkness you are merely referring to her because she has a community interest in this property?      A. That's right.

Q. All your property was community property, wasn't it?      A. That's right.

Q. And she had nothing to do with the business, did she?

A. Well, I will answer that in this way: I have taken a lot of counsel from my wife, and I assure you that her counsel has contributed a lot to my success in this world. [69]

Q. She wasn't down at the place of business operating the place of business, was she, Mr. Harkness?

A. She was born on a ranch, raised on a ranch, taught school when I was working for other people—she taught school to help pay the family bills back when I was working for Mr. Setchel and Associated Fruit Company. She became thoroughly familiar with all phases. She has actually seen every ranch that we ever bought. She has been counseled with on the sale of the products, she has been counseled with on the employment of such people as Mr. Steiger. I introduced Mr. Steiger to her before I ever hired him, and I introduced her to Mr. Sorensen. I introduced her to practically everyone since I have been in the business.

Mr. Mather: Now will you read the question, please?



(Testimony of Floyd J. Harkness.)

(Question read.)

A. She wasn't actually in the office as a stenographer or as an executive, no.

Q. (By Mr. Mather): Or performing any duties in connection with the business?

A. Physical, no; mentally, yes.

Q. What do you mean by "mentally"?

A. Counsel. I just got through——

Q. She discussed your affairs with you as any housewife would or any wife would, didn't she? [70]

A. No. I have always sought her advice on making investments and changes from one job to another. Even from the Setchel Fruit Company to the Associated Fruit Company I asked her, "Should I quit Setchel before he goes broke, and go with the Associated?" and so on and so forth.

Q. Now, after the agreement of December 31, 1942, what change was made in the conduct of the business?

A. No change could be made immediately. I had to continue along paying the high bonuses, high salaries, and putting in an extra lot of hours myself.

Q. Continued just the same as it had prior to 1942, didn't it?

A. No. We had a lot more troubles in '43 and '44 than we ever had in '42.

Q. Well——

A. The war was on, Mr. Mather.

Q. The war was on in '41?



(Testimony of Floyd J. Harkness.)

A. December 8, 1941, we actually declared war, pretty near the end of the year.

Q. How did your business change in its operation after your agreement of December 31, 1942?

A. Let me——

Q. Just answer my question if you can.

A. How did the business operations change?

Q. Yes. [71]           A. They didn't change.

Q. When was the first time they changed after your agreement of December 31, 1942?

A. Well, with the return of Mr. Colgate in October, 1944, that is the first time that one of the partners participated.

Q. He wasn't a partner at that time?

A. He was a representative. Community property gave him half interest in it. He was a resident of California.

Q. It didn't give him any interest in the partnership?

A. Well, as I have testified to here, the primary purpose in the formation of the partnership was to acquire the services of Mr. Colgate.

Q. And as I understand, when he was discharged from the service in 1944 he came with United Packing as an employee?           A. That's right.

Q. Prior to that time he had had no agricultural experience, had he?

A. Except with the Food Machinery Corporation.

Q. Is that agricultural experience?

(Testimony of Floyd J. Harkness.)

A. They service all types of agricultural interests in the San Joaquin Valley. That is 100 per cent of their business, the servicing of agricultural commodities and activities.

Q. How much time had he devoted with that company?

A. He had worked there every school vacation and nine months continuous just prior to his enlistment in the Army. [72]

Q. How old was he in 1942?

A. About 22 or 23.

Q. How much time had he been out of school in 1942?      A. 1942?

Q. Yes.

A. He enlisted in March, I believe it was, of 1941, volunteered with the first contingent of draftees who left Fresno, in order to get his year's service completed and get back into commercial life.

Q. Now, he got in the Army in 1941. Prior to that time when had he graduated from school?

A. He didn't graduate, he quit in 1940 and put in nine months continuous service with the Food Machinery Corporation just prior to his enlistment in the Army.

Q. Prior to that time had he been in school constantly?      A. Yes, sir.

Q. Has your daughter ever performed any services in connection with the business?

A. At what time?

Q. At any time.

(Testimony of Floyd J. Harkness.)

A. Yes, sir. She worked in the office just prior to her marriage for about three months.

Q. In what year? A. 1942.

Q. 1942? [73] A. Yes, sir.

Q. What doing?

A. Secretary to Mr. Bunney who is in charge of the accounting in the office.

Q. Was she paid a salary? A. She was.

Q. What was the highest salary she was ever paid?

A. I would have to ask to see the records on that.

Q. It is not material, I will withdraw the question.

A. Ordinary secretary's salary, I presume, of \$150 a month.

Q. The same salary you paid other people that performed the same services?

A. That's right.

Q. Your son was paid a salary, I believe you testified, of \$150 a month with five per cent bonus?

A. That's right, yes, sir.

Q. Was the five per cent bonus on the income of the business or five per cent bonus on the deals he handled?

A. Five per cent on the over-all picture after deducting Steiger's 25 per cent.

Q. Was that in 1941?

A. That was in 1941.

Q. Do you know how much the total amount he was paid in 1941 was? [74]

(Testimony of Floyd J. Harkness.)

A. His salary for the six months after he got out of college, he was getting \$150 a month, so around \$900; and his five per cent bonus I recall was around \$910 or \$915, such matter.

Q. Now, in 1942 he was paid a salary after he got in the Army, wasn't he? A. Yes, sir.

Q. \$75 a month? A. Yes, sir.

Q. And he carried on some other operations in addition to that, didn't he? A. He did.

Q. Were those deals connected with United Packing Company, or deals of his own?

A. They were crops of Tokay grapes which were shipped through the United Packing Company.

Q. Well, now, were they deals of his own or deals in connection with United Packing?

A. Well, he became a grower, so to speak. The Department of Agriculture has ruled in so many of the marketing agreements that the purchase of a crop changes a purchaser; whether he be a shipper or an attorney, when he buys a crop of Tokay grapes on the vines, he qualifies as a grower.

Mr. Ehrlich: That salary was \$85 a month, Mr. Mather. [75]

Q. (By Mr. Mather): It has been stipulated, Mr. Harkness, that at the time the agreement of December 31, 1942, was entered into that you retained two ranches that were excellent producers. Were those large ranches?

A. One was a 90-acre vineyard, and the other a 40-acre vineyard. At that time the partnership



(Testimony of Floyd J. Harkness.)

was formed, that was all the vineyard property that we owned.

Q. How much vineyard property did United Packing have?      A. At what time?

Q. 1942 when the agreement was entered into?

A. United Packing Company had no vineyard property whatever.

Q. Isn't it a fact they had 90 acres and you had two ranches, one of 40 acres and one of 50 acres at the time?      A. It is not a fact.

Q. Well, at the end of '43, what vineyards did United Packing Company have?

A. The United Packing Company had in conjunction with Mr. Sorensen purchased approximately 300 acres, and United Packing Company had bought from a Japanese who had been evacuated 40 acres on Lincoln Avenue and Tarn Avenue, just four miles south of Sanger. That is to the best of my recollection right now.

Q. What was the Parlier Ranch?

A. That is the one on Lincoln Avenue, I think.

Q. That was turned over to United Packing, wasn't it?

A. That was purchased by the United Packing Company from Wallace Kozuki, an evacuated Japanese.

Q. That was the only property they had that they were operating in 1943 as a ranch, isn't it?

A. No. The so-called River Ranch was a partnership with Chris Sorensen who had an undivided half interest in it.

(Testimony of Floyd J. Harkness.)

Q. That was a separate transaction; that wasn't operated by United Packing, as I understand?

A. It was operated by the United Packing Company.

Mr. Ehrlich: United owned half interest in it?

Mr. Mather: That's right. That is all in the stipulation.

The Court: Will we be able to finish up this afternoon?

Mr. Ehrlich: Yes, your Honor.

The Court: You have some other witnesses?

Mr. Ehrlich: We have the daughter and son and son-in-law. They won't take an hour, your Honor.

The Court: I thought we would adjourn at this time and come back at 2:00 o'clock and finish up.

We will adjourn until 2:00 o'clock.

(Whereupon, at 12:20 o'clock p.m., a recess was taken until 2:00 o'clock p.m.) [77]

Afternoon Session, 2:00 P.M.

Whereupon

FLOYD J. HARKNESS

resumed his testimony as follows:

Cross-Examination

(Resumed)

The Court: You may proceed with your cross-examination.

By Mr. Mather:

Q. Mr. Harkness, I was inquiring about the Parlier Ranch of the partner of the United Packing Company. I believe you testified that that was acquired by the United Packing Company sometime in '43?

A. Yes. As I recall, it was September, 1943.

Q. I show you the partnership income tax return——

Mr. Ehrlich: For what year?

Mr. Mather: '43.

Q. (By Mr. Mather): The '43 schedule form, income and expenses. What does that mean where it says, "Date acquired 1/1/1943," referring to depreciation on those?

A. I presume that means January 1.

Q. That refers to this Parlier Ranch, doesn't it?

A. The 40 acres, yes.

Q. That is the only property they had, that they were operating? [78]

Mr. Ehrlich: You mean United Packing?

(Testimony of Floyd J. Harkness.)

Q. (By Mr. Mather): That is the only property United Packing was operating in 1943, wasn't it?

A. No, they operated the so-called River Ranch, 300-acre ranch.

Q. I am not talking about that, that is covered in the stipulation and that was operated by Sorensen and United Packing received half the income from the operation of that ranch?

A. That's right.

Mr. Mather: I will offer in evidence at this time, if there is no objection, the partnership return of United Packing Company for the year 1943.

(Whereupon the document was marked for identification as Respondent's Exhibit M.)

Mr. Ehrlich: No objection.

The Court: Admitted as Respondent's Exhibit M.

(Whereupon the document marked Respondent's Exhibit M for identification was received.)



(Testimony of Floyd J. Harkness.)

RESPONDENT'S EXHIBIT M

Form 1065

Page 1

Treasury Department

Internal Revenue Service

United States

Partnership Return of Income

1943

(To be Filed Also by Syndicates, Pools, Joint Ventures, Etc.)

For Calendar Year 1943

or fiscal year beginning ....., 1943, and ending ....., 1944

(File this return not later than the 15th day of the 3d month following the close of the taxable year)

(Print Plainly Name and Business Address of the Organization)

(Name) United Packing Co.

(Street and number) 216 Rowell Bldg.

(City or town) Fresno (State) California

Business or Profession Growers-Shippers

Item & Inst. No.

Gross Income

1. Gross receipts from business or profession  
see attached schedule .....\$294,026.82

2. Less cost of goods sold:  
(a) Inventory at beginning of year  
(b) Merchandise bought for sale  
(c) Cost of labor, supplies, etc.  
(d) Total of lines (a), (b), and (c)  
(e) Less inventory at end of year

3. Gross profit (or loss) from business or profession  
(item 1 minus item 2) ..... 294,026.82

4. Income (or loss) from other partnerships,  
syndicates, pools, etc. (State separately  
name, address, and amount):  
United Pkg. Co. and C. A. & Katherine  
Sorensen—Fresno ..... 60,309.92

5. Interest on bank deposits, notes, etc.

6. Interest on corporation bonds, etc. (except  
interest to be reported in item 7)

7. Interest on tax-free covenant bonds upon  
which a Federal tax was paid at source

8. Interest on Government obligations, etc.:

(a) From line (h), Schedule A

(b) From line (i), Schedule A

9. Rents

10. Royalties

11. Net gain (or loss) from sale or exchange of  
property other than capital assets  
(from Schedule B)

## (Testimony of Floyd J. Harkness.)

12.	Dividends	
13.	Other income (state nature of income) :	
	Form #1040-F attached .....	7,245.26
14.	Total income in items 3 to 13 (enter nontaxable income in Schedule A and G) .....	\$361,582.00
Deductions		
15.	Salaries and wages (do not include compensation for partners)	
16.	Rent	
17.	Repairs	
18.	Interest on indebtedness (explain in Schedule F)	
19.	Taxes (explain in Schedule C)	
20.	Losses by fire, storm, shipwreck, or other casualty, or theft (submit schedule)	
21.	Bad debts (explain in Schedule D)	
22.	(a) Depreciation (explain in Schedule E)	
	(b) Amortization of emergency facilities (attach statement)	
23.	Depletion of mines, oil and gas wells, timber, etc. (submit schedule)	
24.	Other deductions authorized by law (explain in Schedule F)	
25.	Total deductions in items 15 to 24 .....	0
26.	Ordinary net income (item 14 minus item 25)....	\$361,582.00
27.	Net short-term capital gain (or loss) (from line 1, column 4, Summary, Schedule H)	
28.	Net long-term capital gain (or loss) (from line 2, column 4, Summary, Schedule H)	

Page 2

## Schedule A.—Interest on Government Obligations, Etc.

[No data recorded in this section.]

Schedule B.—Gains and Losses From Sales or Exchanges of Property  
Other Than Capital Assets

[No data recorded in this section.]

## Schedule C.—Taxes

[No data recorded in this section.]

## Schedule D.—Bad Debts

[No data recorded in this section.]

(Testimony of Floyd J. Harkness.)

Schedule E.—Depreciation

[No data recorded in this section.]

Schedule F.—Explanation of Deductions Claimed in Items 18 and 24

[No data recorded in this section.]

Page 3

Schedule G.—Nontaxable Income Other Than Interest Reported in  
Schedule A

[No data recorded in this section.]

Schedule H.—Gains and Losses From Sales or Exchanges of  
Capital Assets

[No data recorded in this section.]

Schedule I.—Contributions or Gifts Paid

[No data recorded in this section.]

(Testimony of Floyd J. Harkness.)

Schedule J.—Partners' Shares of Income and Credits. (See Instruction 29)

Page 4

1. Name and address of each partner Where return of partner or member is filed in another collection district, specify district If the full time of any partner was not devoted to the business, the percentage of time devoted must be stated	2. Ordinary net income less interest on Government obligations, etc., subject to surtax only (item 26, page 1, minus item 8(a), page 1)	3. Net short-term gain (or loss) from sale or ex- change of capital assets (from Schedule H, Sum- mary, line 1, column 4)	4. Net long-term gain (or loss) from sale or ex- change of capital assets (from Schedule H, Sum- mary, line 2, column 4)
(a) Floyd J. Harkness, 3767 Huntington, Fresno, Cal. ....	\$146,645.50	\$ .....	\$ .....
(b) Floyd J. Harkness, Jr.,* 3767 Huntington, Fresno, Cal. ....	71,645.50	.....	.....
(c) Molly A. Harkness, 3767 Huntington, Fresno, Cal. ....	71,645.50	.....	.....
(d) Harriet Harkness Colgate, 3767 Huntington, Fresno, Cal. ....	71,645.50	.....	.....
(e) .....	.....	.....	.....
(f) *India-China Wing—ATC—U.S. Army	.....	.....	.....
(g) .....	.....	.....	.....
Totals.....	<u>\$361,582.00</u>	.....	.....

Continuation of Schedule J

[No data recorded in this section.]



(Testimony of Floyd J. Harkness.)

Questions

1. Date of organization 1/1/43.
2. Nature of organization (partnership, syndicate, pool, joint venture, etc.) Partnership.
3. Was a return filed for preceding year? No. If so, to which collector's office was it sent?
4. Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
5. State whether inventories at the beginning and end of the taxable year were valued at (a) cost, or (b) cost or market, whichever is lower (a).

If any other basis is used, attach statement describing basis fully, state why used and the date inventory was last reconciled with stock

6. Did the organization at any time during its taxable year have in its employ more than eight individuals? (Answer "Yes" or "No") Yes.

If answer is "Yes," has the organization in this return taken a deduction for any amount of wages or salaries representing an increase or decrease in rate during the taxable year? (Answer "Yes" or "No") No. If answer to second question is "Yes," attach a statement explaining all such increases or decreases. If any of such increases or decreases required the prior approval of the National War Labor Board or the Commissioner of Internal Revenue as stated in instruction 15, attach also a copy of the authorization for each of such increases or decreases.

7. Did the organization at any time during the taxable year own directly or indirectly any stock of a foreign corporation or a personal holding company, as defined in section 501 of the Internal Revenue Code? (Answer "Yes" or "No") No.

If answer is "Yes," attach schedule required by Instruction I.

8. Was return of information on Forms 1096 and 1099, or Forms V-2 and W-2, filed for the calendar year 1943? (See Instruction H) Yes.

Affidavit (See Instruction D)

I/we swear (or affirm) that this return (including any accompanying schedules and statements) has been examined by me/us, and to the best of my/our knowledge and belief is a true, correct, and complete return, made in good faith, for the accounting period stated, pursuant to the Internal Revenue Code and the regulations issued under authority thereof.

(Partner or member) F. J. Harkness (Date) 3-9-44

216 Rowell Bldg., Fresno, Calif.

(Address of partner or member)

Subscribed and sworn to before me this 9th day of March, 1944.

Julius Hansen, Notary Public.

## (Testimony of Floyd J. Harkness.)

United Packing Co.—Fresno, Calif.

## Statement of Income and Expense—1943

## Income

Material Gain: Clovis .....	\$ 2,268.06	
Lodi .....	4,986.42	
Sanger .....	5,142.22	
Tagus .....	1,695.50	
	<hr/>	14,092.20
Labor & Earnings: Clovis .....	73,378.48	
Lodi .....	21,617.34	
Sanger .....	123,539.34	
Tagus .....	41,628.77	
	<hr/>	260,163.93
Commissions: Arvin .....	15,743.54	
Clovis .....	2,151.37	
Exeter .....	250.00	
Firebaugh .....	1,563.65	
Lodi .....	87.85	
Sanger .....	49,310.58	
	<hr/>	69,106.99
Growing Deals & Leases: Arvin .....	2,222.79	
Lodi .....	50,341.47	
Sanger .....	21,058.25	
	<hr/>	73,622.51
Midway .....	—9,453.00	
	<hr/>	64,169.51
Claims .....		3,702.12
Interest .....		321.49
Discount .....		8,530.85
Truck Earnings .....		990.66
		<hr/>
		\$421,077.75

(Testimony of Floyd J. Harkness.)

Expense

Packing House: Arvin .....	\$ 1,284.84	
Clovis .....	1,766.09	
Exeter .....	106.37	
Firebaugh .....	1,035.73	
Lodi .....	3,095.89	
Sanger .....	10,017.01	
Tagus .....	644.26	
	<hr/>	
	17,950.19	
General .....	26,675.40	
Depreciation (schedule attached) .....	6,134.01	
	<hr/>	
		50,759.60
		<hr/>
		370,318.15
Sanger & Clovis District Manager's Share .....		53,283.59
		<hr/>
		317,034.56
Bonuses to key employees:		
Sales Manager .....	7,532.96	
Office Manager .....	7,532.96	
Arvin-Lodi Manager .....	7,941.82	
	<hr/>	
		23,007.74
		<hr/>
Net Profit .....		\$294,026.82

## United Packing Co.—Fresno, Calif.

## Depreciation Schedule

Assets	Date Acquired	Cost	Estimated Life	Deprec. 1943
Packing Sheds .....	1930-42	\$14,039.20	14 yrs.	\$1002.80
Packing Shed Equipment .....	.....1939	653.66	5 yrs.	\$130.73
Packing Shed Equipment .....	.....1940	2,283.07	5 yrs.	456.61
Packing Shed Equipment .....	.....1941	1,756.79	5 yrs.	351.36
Packing Shed Equipment .....	.....1942	1,517.40	5 yrs.	303.48
Packing Shed Equipment .....	.....1943	2,689.65	5 yrs.	537.93
<hr/>				
Office Equipment .....	.....1934-43	1,414.73	10 yrs.	1780.11
				141.48
1940 GMC Truck .....	.....1940	1,127.85	Balance	187.98
1941 Buick .....	.....1941	1,352.70	4 yrs.	338.17
1941 Dodge .....	.....1941	817.60	4 yrs.	204.40
1942 Buick .....	.....6-17-42	1,809.06	4 yrs.	452.27
1942 Dodge .....	.....10-29-42	1,575.92	4 yrs.	393.98
1932 Ford Bus .....	.....6-15-42	300.00	3 yrs.	100.00
1935 Chevrolet Truck .....	.....6-15-42	300.00	3 yrs.	100.00
1929 Chevrolet Truck .....	.....7-12-42	200.00	3 yrs.	66.67
1936 Ford Truck .....	.....8-31-42	590.33	3 yrs.	196.78



1931 Chevrolet Truck .....	12-23-42	100.00	2 yrs.	50.00	<hr/>	2097.19	
1937 Studebaker Truck .....	11-29-43	250.00	3 yrs.	6.94			
Otani Tractor .....	5-15-42	1,290.56	5 yrs.			258.11	
Case Tractor .....	.....1940	1,342.25	4 yrs.	335.57	<hr/>	684.59	
AC Tractor .....	.....1941	1,000.00	4 yrs.	250.00			
LA Tractor .....	11-27-43	1,806.24	4 yrs.	64.51			
Duster .....	9-15-43	517.63	5 yrs.	34.51			
Case Tractor .....	.....10-12-43	1,054.57	4 yrs.	43.94	<hr/>	169.73	
Case Cultivator .....	.....10-12-43	160.22	5 yrs.	5.34			
Miscellaneous Tools .....	.....1940	602.25	5 yrs.	120.45			
						<hr/>	\$6134.01

(Testimony of Floyd J. Harkness.)

Form 1040 F

Page 1

Treasury Department                      United States  
Internal Revenue Service

Schedule of Farm Income and Expenses                      1943  
For Calendar Year 1943

Or for year beginning ....., 1943, and ending ....., 1944

Name United Packing Co. — Parlier Ranch  
Address P.O. Box 546, Fresno, Calif.  
Location of farm or farms Parlier, California  
Number of acres in each farm 40

Farm Income for Taxable Period

- |  |   |
|--|---|
| 1. Sale of Livestock Raised<br>[No data supplied.] | 2. Sale of Produce Raised<br>Fruits & Raisins.....\$18,277.59       |
|  | Total.....\$18,277.59   |
| 3. Other Farm Income<br>[No data supplied.]        | 4. Sale of Livestock & Other Items Purchased<br>[No data supplied.] |

Summary of Income and Deductions Computed on a Cash Receipts  
and Disbursements Basis

- |   |                               |
|---|-------------------------------|
| 1. Sale of livestock raised.  | 6. Expenses                   |
| 2. Sale of produce raised..\$18,277.59  | (from page 3) ....\$ 9,625.50 |
| 3. Other farm income.   | 7. Depreciation               |
| 4. Profit on sale of livestock<br>and other items purchased.                            | (from page 3).... 1,406.83    |
|   | 8. Total De-                  |
| 5. Gross Profits .....\$18,277.59   | ductions.....\$10,032.33      |
| 9. Net farm profit (line 5 minus line 8) to be reported in<br>item 8 on Form 1040 ..... | \$ 7,245.26                   |

Page 2

Farm Inventory for Income Computed on an Accrual Basis  
[No data supplied.]

Summary of Income and Deductions Computed on an Accrual Basis  
[No data supplied.]

## (Testimony of Floyd J. Harkness.)

## Farm Expenses for Taxable Year (See Instructions)

1. Items	2. Amount
Labor hired .....	\$5,406.75
Feed purchased .....	67.05
Seed, plants, and trees purchased .....	
Spraying, Etc. ....	160.61
Supplies purchased .....	126.12
Cost of repairs and maintenance .....	802.09
Breeding fees .....	
Fertilizers and lime .....	1,120.93
Veterinary and medicine for livestock .....	
Gasoline, other fuel and oil for farm business .....	690.14
Storage and warehousing .....	
Taxes .....	243.06
Insurance on property (except your dwelling) .....	169.73
Interest on farm notes and mortgages .....	73.09
Water rent, electricity, and telephone .....	316.56
Rent of farm, part of farm, or pasturage .....	
Freight, yardage, express, and trucking .....	81.33
Automobile upkeep (farm share) .....	246.34

3. Items  
(Continued)

4. Amount  
(Continued)

Other farm expenses (specify) :

Miscellaneous .....\$ 121.70

Total of Columns 2 and 4 (enter on line 6 of summary on  
page 1 (cash basis) or line 7, page 2 (accrual basis) ) .....\$9,625.50

## (Testimony of Floyd J. Harkness.)

## Depreciation (See Instructions)

1. Kind of property (if buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (do not include land or other nondepre- ciable property)	4. Assets fully de- preciated in use at end of year	5. Depreciation allowed (or allow- able) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in accumulating depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
Vineyard	1/1/43	\$2875.00	0	0	\$2875.00	0	20	\$143.75
Orchard	1/1/43	1035.00	0	0	1035.00	0	20	51.75
Buildings	1/1/43	5000.00	0	0	5000.00	0	15	333.33
Tractor	1/1/43	1000.00	0	0	1000.00	0	4	250.00
Farm Tools	1/1/43	1256.00	0	0	1256.00	0	5	251.20
Picking Equip.	1/1/43	1784.00	0	0	1784.00	0	5	356.80
Horses	1/1/43	100.00	0	0	100.00	0	5	20.00

Total (enter on line 7 of summary on page 1 (cash basis) or line 8, page 2 (accrual basis) ) .....\$1406.83

Remarks:

Page 4

## Instructions

Form 1040 F—Treasury Department Internal Revenue Service

[Not Printed.]

Admitted in evidence: January 11, 1949.



(Testimony of Floyd J. Harkness.)

Q. (By Mr. Mather): Now, the two ranches that you had that weren't in the partnership, were they 40 acres and 50 acres?

A. No, sir, 40 acres and 90 acres.

Q. Well, I will show you your income tax return for 1943 and the farm schedule attached to that. It shows Selma [79] Ranch, 90 acres, and then over in here in the depreciation schedule it shows vineyard, 40 acres, and new vines, 50 acres.

Q. What does that mean?

A. That means that I bought a 90-acre piece of land from the California Lands as a holding company for the Bank of America, and on that acreage there was 40 acres of producing vines and 50 acres of new vines on the same piece of property.

Q. Well, now, what ranches were you operating individually in 1943?

A. That same 90 acres there, of which 40 acres was producing vines of old age when I acquired it, and the 50 acres of new vines that were planted, I think in about 1938 or '39 on the same ranch.

Q. Those were the only ranches that you had at that time that you were operating?

A. No, sir. I owned a ranch of 40 acres called the Earl Ranch; bought that from Fred P. Holm, situated on the corner of Mountain View and Van Horn Avenue, one mile south and east of Selma, California.

Q. Were you operating that in '43?

A. I was.

Q. Take your return and show me any place in

(Testimony of Floyd J. Harkness.)

there where there is income or loss for anything other than the Selma Ranch of 90 acres?

A. I think in your files you have a partnership return [80] of Earl D. Harkness and Gladys Harkness, and Floyd J. Harkness and Molly A. Harkness. I had previous to 1943 sold my brother a half interest in that 40 acres.

Q. Well, now, refer to the return which is before you and just tell me any place that any reference is made to any ranch property other than the 90-acre Selma Ranch. Maybe I can help you.

A. All right, I would appreciate it.

Q. Referring to the return now, can you answer my question, Mr. Harkness?

A. Yes, sir. It says, "Income from partnerships," and so forth, and it shows there the United Packing Company partnership, and it shows a partnership existing between F. J. and Molly A. Harkness and E. D. and Gladys Harkness with an income of \$2,021.38.

Q. That was operated as a partnership?

A. With my brother.

Q. Wasn't one of the properties referred to in the stipulation as the two properties which you retained and had not turned over to the partnership?

A. Earl D. and Gladys Harkness are not a member of the United Packing Company.

Q. Another thing I want to get straight is income on your '43 return other than United Packing income is shown as dividends and 50 per cent of the

(Testimony of Floyd J. Harkness.)

Selma Ranch operation, and that [81] is all the gross income you show on that return, isn't it?

A. This says "Income or loss from partnerships" (plural). That means my partnership arrangement with United Packing Company and partnerships (plural), that means with Earl D. and Gladys Harkness.

Q. OK.

A. That does not say "Income from United Packing Company."

Q. All right. All I am trying to find out is where this \$11,000 of income from other sources that is shown in Exhibit 18 is disclosed in your '43 return.

Mr. Ehrlich: Mr. Mather, Mr. Bunney is the bookkeeper. Can you have him do it?

Q. (By Mr. Mather): Now, I think I can straighten you out on this, Mr. Harkness. Exhibit 18 shows \$11,000 odd of other income other than partnerships.

Mr. Ehrlich: Other than United Packing Company.

Q. (By Mr. Mather): Other than United Packing Company, and that is represented by the \$1,500 dividends, \$2,100 farm income, and the balance is in this \$111,000 partnership income. That is your understanding?

A. Yes, sir.

Mr. Ehrlich: Including his wife's, Mr. Mather.

Q. (By Mr. Mather): It is only your half, your community interest?

A. That's right.



(Testimony of Floyd J. Harkness.)

Mr. Mather: I will offer in evidence Mr. Harkness' '43 return.

(Whereupon the document was marked for identification as Respondent's Exhibit N.)

The Court: Admitted as Respondent's Exhibit N.

(Whereupon the document marked Respondent's Exhibit N for identification was received.)

RESPONDENT'S EXHIBIT N

Form 1040 Page 1

Treasury Department  
Internal Revenue Service      United States  
Individual Income and Victory Tax Return      1943  
For Calendar Year 1943

for fiscal year beginning ....., 1943, and ending ....., 1944

(Name) Floyd J. Harkness  
(Street) 3767 Huntington Blvd.  
(City) Fresno      (State) California

Occupation Grower-Shipper      Social Security number, if any.....

Computation of Net Income

Income

Column 1 Income Tax Net Income	Column 2 Victory Tax Net Income
--------------------------------------	---------------------------------------

- |   |             |             |
|---|-------------|-------------|
| 1. Salary, Wages, and Compensation for Personal Services.   |             |             |
| 2. Dividends.   |             |             |
| 3. Interest on corporation bonds,<br>bank deposits, notes, etc. ....  | \$ 1,527.08 | \$ 1,527.08 |
| 4. Interest on Government obligations, etc. :<br>(a) From line A (8), Schedule A<br>(b) From line B (5) and (3), Schedule A   |             |             |
| 5. Annuities.   |             |             |
| 6. (a) Net gain (or loss) from sale or exchange<br>of capital assets. (From Schedule B)<br>(b) Net gain (or loss) from sale or exchange of<br>property other than capital assets. (From Schedule B) |             |             |



(Testimony of Floyd J. Harkness.)

7.	Rents and royalties. (From Schedule C(1) )		
8.	Net profit (or loss) from business or profession. 50% of #104 of att'd. ....	2,164.92	2,164.92
	(State total receipts, from line 1, Schedule C(2) \$....)		
9.	Income (or loss) from partnerships; fiduciary income; and other income. (From Sched. C(3) )..	111,166.88	111,166.88
10.	Total income in items 1 to 9.....	\$114,858.88	\$114,858.88

Deductions

11.	Contributions. (Explain in Schedule D)		
12.	Interest. (Explain in Schedule E) (See In- structions 12 and 16 for Victory Tax deduction) .....	\$ 288.41	x x x x
13.	Taxes. (Explain in Schedule F) (See Instructions 13 and 16 for Victory Tax deduction) .....	6,191.98	x x x x
14.	Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule G)		x x x x
15.	Medical, dental, etc., expenses. (Explain in Schedule H)		x x x x
16.	Other deductions authorized by law. (Explain in Schedule G) .....	216.90	\$ 216.90
17.	Total deductions in items 11 to 16.....	\$ 6,697.29	\$ 216.90
18.	Income Tax net income (item 10, col. 1, less item 17, col. 1) .....	\$108,161.59	x x x x
19.	Victory Tax net income (item 10, col. 2, less item 17, col. 2) .....	x x x x	\$114,641.98

Income and Victory Tax

20.	Unpaid balance of 1943 Income and Victory Tax (from line 22, page 4) .....	\$10,397.86	
21.	You may postpone, until not later than March 15, 1945, payment of the amount you owe up to one-half of item 19(c), page 4. Enter the amount postponed. (For persons whose surtax net income for 1942 or 1943 exceeded \$20,000, see Schedule L-2) .....	4,617.12	
22.	Amount paid with this return (item 20 less item 21).....	\$ 5,780.74	
23.	Refund or Credit. [None shown.]		

I declare under the penalties of perjury, that this return (including any accompanying schedules and statements) has been examined by me

and to the best of my knowledge and belief is a true, correct, and complete return.

Floyd J. Harkness                      March 10, 1944.  
(Signature of taxpayer)                      (Date)

Page 2

## Those Whose Income Is Solely From Salaries May Disregard This Page

### Schedule A.—Interest and Ownership of Taxable Government Obligations, Etc.

[No data recorded in this section.]

**Schedule B.**—Schedule B (Form 1040) is a separate sheet and should be used in reporting gains and losses from sales or exchanges of capital assets and property other than capital assets, and filed with and as a part of this return.

Schedule C(1).—Income From Rents and Royalties

[No data recorded in this section.]

Schedule C (2).—Profit (or Loss) From Business or Profession

[No data recorded in this section.]

**Schedule C(3).—Income From Partnerships, Fiduciaries,  
and Other Sources. (See Instruction 9)**

Name and address of partnership, syndicate, etc.	United Packing Co., Fresno, Calif.	Amount, \$109,145.50
--	---------------------------------------	----------------------

Name and address F. J. & Molly A. & E. D. & Gladys Harkness .....	Amount,	2,021.38
Other income (state nature) .....	Amount,	

Total (enter as item 9, page 1) .....\$111,166.88  
Page 3

### Schedule D.—Contributions

[No data recorded in this section.]

Schedule E.—Interest. (See Instruction 12)

1. To Whom Paid	2. Amount
-----------------	-----------

Federal Land Bank, mortgage .....	\$288.41
Total. (Enter as item 12, page 1) .....	\$ .....

Schedule F.—Taxes. (See Instruction 13)

1. Nature	2. Amount
-----------	-----------

Fresno City & County taxes .....	\$ 455.60
Calif. State Income Tax .....	5,736.38

Total. (Enter as item 13, page 1) .....\$6,191.98

(Testimony of Floyd J. Harkness.)

Schedule G.—Losses and Other Deductions. (See Inst. 14 and 16)

1. Item No.	2. Explanation	3. Amount
16	Expenses away from home in pursuit of business .....	\$216.90

Schedule H.—Medical, Dental, Etc., Expenses

[No data recorded in this section.]

Schedule I.—Personal Exemption and Credit for Dependents  
(See Tax Computation Instructions)

(1) Personal Exemption

Status	Number of months during the yr. in each status	Credit claimed
Single, or married and not living with husband or wife, and not head of family .....		
Married and living with husband or wife .....	12	\$100.00
Head of a family (explain below) .....		

(2) Credit for Dependents

Name of dependent and relationship	Number of months during the year Under 18      18 years years old      or over	Credit claimed (Head of a family may not claim credit for dependent used to qualify him as head of a family)
Emma F. Harkness .....	12	\$350.00
(Mother)		

Reason for support if 18 years or over Physically incapable.

Schedule J.—Computation of Earned Income Credit  
(See Tax Computation Instructions)

(1) If your net income is \$3,000 or Less, use only this part of schedule  
[No data recorded in this section.]

(2) If your net income is More than \$3,000, use only this  
part of schedule

Earned net income (not more than \$14,000) .....	\$ 14,000.00
Net income (item 18, page 1) .....	108,161.59
Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but do not enter less than \$300) .....	1,400.00

Questions

- Did you file a return for any prior year? Yes. If so, what was the latest year? 1942. To which Collector's office was it sent? San Francisco.
- If you claimed credit for tax paid in line 21 (c), page 4, to which Collector's office was your declaration sent? San Francisco.
- If separate return was made for the current year, state:
  - Name of husband or wife Molly A. Harkness.
  - Personal exemption, if any, claimed thereon 1,100.00.
  - Collector's office to which it was sent San Francisco.



## (Testimony of Floyd J. Harkness.)

4. Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
5. Was the rate of your salary or wages increased or decreased during your taxable year? (Yes or No) .....
6. Did you receive during your taxable year any amount claimed to be nontaxable (see General Instruction I)? No. If so, attach schedule showing source, nature, and amount of such income.
7. Did you at any time during your taxable year own directly or indirectly any stock of a foreign corporation, or a personal holding company as defined by section 501 of the Internal Revenue Code? No. If so, attach statement required by General Instruction L.

Page 4

Computation of Income and Victory Tax  
(See Tax Computation Instructions)

1. Income Tax net income (item 18, page 1) .....	\$108,161.59	
2. Less: Personal exemption. (From Schedule I-(1) ) .....	\$ 100.00	
3. Credit for dependents. (From Schedule I-(2) ) .....	350.00	450.00
4. Balance (surtax net income) .....		\$107,711.59
5. Less: Certain interest on Government obligations (item 4 (a), page 1)		
6. Earned income credit. (From Schedule J-(1) or J-(2) ) .....	1,400.00	1,400.00
7. Balance subject to normal tax .....		\$106,311.59
8. Normal tax (6% of line 7) .....	\$ 6,378.68	
9. Surtax on amount in line 4. (See Surtax Table, page 3 of Instructions) .....	65,232.16	
10. Total Income Tax (line 8 plus line 9). (If Schedule B is used and alternative tax computation made, enter line 16, Schedule B) .....	\$ 71,610.84	
11. Less: Income Tax paid to a foreign country or U. S. possession. (Attach Form 1116) .....		0
12. Balance of Income Tax .....	\$ 71,610.84	
13. Net Victory Tax (line 6 of Victory Tax Schedule, below) .....	5,100.90	
14. Total of lines 12 and 13 .....	\$ 76,711.74	



## (Testimony of Floyd J. Harkness.)

15. Income Tax paid at source on tax-free covenant bond interest (See Footnote 1) .....	0
16. Line 14 less line 15 .....	\$ 76,711.74
17. Income Tax for 1942. (See Statement, Form 1125, from Collector) (First, see page 4 of Instructions) .....	\$ 36,936.99
18. Enter line 16 or 17 whichever is Larger. (Members of the armed forces see page 4 of Instructions) .....	\$ 76,711.74
19. Forgiveness Feature (Don't fill in (a), (b), and (c) below, if either line 16 or 17 is \$50 or less):	
(a) Enter line 16 or 17, whichever is Smaller .....	\$36,936.99
(b) Enter \$50 or three-fourths of (a), immediately above, whichever is Larger. This is the Forgiven part of the tax .....	\$27,702.74
(c) Enter the Unforgiven part of the tax which is the Balance (subtract (b) from (a) ). (See Footnote 2) .....	9,234.25
20. Total Income and Victory Tax. (Total of lines 18 and 19 (c) ) .....	\$ 85,945.99
21. Less: (a) Income and Victory Tax withheld by employer .....	0
(b) Income Tax paid on 1942 income .....	\$18,468.50
(c) Tax paid on 1943 income on account of Declaration of Estimated Tax....	57,079.63
(d) Total payments .....	75,548.13
22. Unpaid Balance of Income and Victory Tax. (If line 20 is larger than line 21 (d), enter the difference here and also as item 20, page 1; if not, see item 23, page 1) ..	\$ 10,397.86

Footnote 1.—If you claim a credit in line 15, disregard lines 19 (a) and (b), complete Schedule L-1 on page 4 of Instructions, and enter result in line 19 (c). Attach completed schedule.

Footnote 2.—If your surtax net income for 1942 or 1943 exceeded \$20,000, requiring you to complete Schedule L-2, enter here the amount shown on line 10 or 27 of such schedule, \$..... and increase 19 (c) by such amount.

## Schedule K.—Victory Tax. (See Tax Computation Instructions)

1. Victory Tax net income (item 19, page 1) .....	\$ 14,641.98
2. Less: Specific exemption (\$624 if return reports income of only one person; otherwise, see Instructions, page 3) .....	624.00
3. Income subject to Victory Tax (line 1 less line 2) .....	\$ 14,017.98
4. Victory Tax before credit (5% of line 3) .....	\$ 5,700.90

## (Testimony of Floyd J. Harkness.)

## 5. Victory Tax credit:

- (a) Single person, or married person not living with husband or wife: 25% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent).
- (b) Married person living with husband or wife if separate returns are filed: 40% (plus 2% for each dependent) of line 4, but not more than \$500 (plus \$100 for each dependent) .....\$ 600.00
- (c) Married person living with husband or wife if only one return or a joint return is filed, or head of a family: 40% (plus 2% for each dependent) of line 4, but not more than \$1,000 (plus \$100 for each dependent). (See Schedule I-(2), for exclusion of one dependent by head of a family).

## 6. Net Victory Tax (line 4 less line 5). (Enter in line 13, above) .....\$ 5,100.90

Schedule L.—To be used only by individuals whose surtax net income for 1942 or 1943 exceeded \$20,000

Schedule to determine whether Section 6 (c) of the Current Tax Payment Act of 1943 is applicable

[No data recorded in this section.]

Form 1040 F

Treasury Department

Page 1

Internal Revenue Service United States

Schedule of Farm Income and Expenses

1943

For Calendar Year 1943

Or for year beginning ....., 1943, and ending ....., 1944

Name F. J. & Molly A. Harkness (Selma Ranch)

Address 3767 Huntington Blvd., Fresno, Calif.

Location of farm or farms Route 2, Box 93, Selma, Calif.

Number of acres in each farm 90

Farm Income for Taxable Period

1. Sale of Livestock Raised

[No data recorded in this section.]

2. Sale of Produce Raised

Cotton .....\$ 120.59

Other (specify):

Raisins ..... 19,051.46

Total.....\$19,172.05

(Enter on line 2 of summary below)

(Testimony of Floyd J. Harkness.)

3. Other Farm Income

Agricultural program payments .....\$61.34

Total.....\$61.34

(Enter on line 3 of summary below)

4. Sale of Livestock and Other Items Purchased

[No data recorded in this section.]

Summary of Income and Deductions Computed on a Cash  
Receipts and Disbursements Basis

1. Sale of livestock raised.	
2. Sale of produce raised .....	\$19,172.05
3. Other farm income .....	61.34
4. Profit on sale of livestock and other items purchased.	
5. Gross Profits .....	\$19,233.39
6. Expenses (from page 3) .....	\$13,379.86
7. Depreciation (from page 3) .....	1,523.69
8. Total Deductions .....	\$14,903.55
9. Net farm profit (line 5 minus line 8) to be reported in item 8 on Form 1040 .....	\$ 4,329.84

Page 2

Farm Inventory for Income Computed on an Accrual Basis

[No data recorded in this section.]

Summary of Income and Deductions Computed on an Accrual Basis

[No data recorded in this section.]

Page 3

Farm Expenses for Taxable Year (See Instructions)

1. Items	2. Amount
Labor hired .....	\$8,442.26
Feed purchased.	
Seed, plants, and trees purchased .....	298.32
Machine hire .....	60.00
Supplies purchased .....	503.99
Cost of repairs and maintenance .....	916.78
Breeding fees.	
Fertilizers and lime .....	1,148.27
Veterinary and medicine for livestock .....	5.50
Gasoline, other fuel and oil for farm business .....	425.46
Storage and warehousing.	
Taxes .....	324.29

(Testimony of Floyd J. Harkness.)

Insurance on property (except your dwelling) .....	185.71
Interest on farm notes and mortgages .....	360.50
Water rent, electricity, and telephone .....	316.31
Rent of farm, part of farm, or pasturage.	
Freight, yardage, express, and trucking.	
Automobile upkeep (farm share) .....	102.72

3. Items (Continued)	4. Amount (Continued)
<hr/>	
Other farm expenses (specify) :	
Spray and sulphur .....	\$ 289.75
Total of Columns 2 and 4 (enter on line 6 of summary on	
page 1 (cash basis) or line 7, page 2 (accrual basis) ).....	\$13,379.86



(Testimony of Floyd J. Harkness.)

Depreciation (See Instructions)

1. Kind of property (if buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (do not include land or other nondepre- ciable property)	4. Assets fully de- preciated in use at end of year	5. Depreciation allowed (or allow- able) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in accumulating depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
Vineyard 40 A. ....	1/41	\$6991.86	0	\$1165.30	\$5826.56	2	10	\$582.65
Buildings .....	1/41	4093.62	0	545.82	3547.80	2	13	272.91
New Vyd. 50 A. ....	1/41	2237.08	0	0	2237.08	0	20	111.85
Shed .....	5/42	330.85	0	14.71	316.14	8 mo.	14	22.06
Pipeline .....	2/42	1203.78	0	66.88	1136.90	10 mo.	14	80.25
Tractor .....	1941	875.50	0	437.74	437.76	2	2	218.88
Farming Tools .....	1941	585.50	0	234.20	351.30	2	3	117.10
Team Mules .....	1941	278.75	0	111.50	167.25	2	3	55.75
Refrigerator .....	1942	125.00	0	25.00	100.00	1	4	25.00
Tools, Boxes .....	1942	186.22	0	37.24	148.98	1	4	37.24
Total (enter on line 7 of summary on page 1 (cash basis) or line 8, page 2 (accrual basis) ) .....								\$1523.69

Remarks:

Page 4

Instructions  
Form 1040 F—Treasury Department Internal Revenue Service  
[Not Printed]

Admitted in evidence Jan. 11, 1949.

(Testimony of Floyd J. Harkness.)

Mr. Mather: If your Honor please, those returns are for my files, and I will ask leave to substitute photostats.

The Court: You may substitute a photostatic copy for each of the exhibits, M and N.

Q. (By Mr. Mather): Now, Mr. Harkness, 1942 had been a pretty successful year, hadn't it?

A. Yes. We had been able to take advantage of the war effort before any regulations had become effective.

Q. As a matter of fact, your income for '41 was about \$22,000, and 1942, \$141,000.

A. That is approximately correct, yes.

Q. It is so stipulated. A. Yes.

Q. That is, income from United Packing? [83]

Mr. Ehrlich: That is correct.

Q. (By Mr. Mather): I assume you had tax advice with respect to preparing your returns?

A. I did.

Q. And you knew that you were approaching the 50 per cent bracket with respect to surtax in 1942?

A. I paid a tax, I believe it was about that.

Q. And you appreciated if 1943 was as successful a year as '42 that you would still be in the 50 per cent bracket? A. Yes, sir.

Q. And if that income were allocated between the family group, why, your income tax would be considerably less? A. Yes, sir.

Q. What effect did that have on the creation of this agreement of December 31, 1942?

(Testimony of Floyd J. Harkness.)

A. I stated this morning that I would have formed the partnership regardless of the tax.

Q. But you appreciated the tax saving?

A. I appreciated it.

Q. Well, you knew about it?

A. Well, I knew about it, yes.

Q. I have a couple of other questions, Mr. Harkness. At the time the agreement of December 31, 1942, was entered into, did either your son or your daughter have any [84] property of their own?

A. No. My son had no money and some credit on the books of United Packing Company, but they had both just graduated within a year from college, within a year prior to the formation of the partnership.

Q. Was there any transfer of property to United Packing Company at the time of this agreement?

Mr. Ehrlich: What do you mean, Mr. Mather?

Q. (By Mr. Mather): I will clarify that. What documents transferring any interest to your son and daughter were made December 31, 1942, other than the partnership agreement? In other words, were there any bills of sale?

A. No. There was an assignment of an interest in the United Packing Company.

Q. That was in the partnership agreement, wasn't it? A. Yes, sir.

Q. I am asking other than the partnership agreement if there was any document of any kind or character executed other than the partnership agreement conveying any interest to your children?

(Testimony of Floyd J. Harkness.)

A. No. My legal advisors had advised that that was, and it so states in the agreement itself, that that was——

Q. I am not interested in that. I am just asking if there was any agreement other than the partnership agreement [85] making any transfer?

A. No, sir.

Q. And the real estate that went into the partnership, that was carried in the same manner as prior to December 31, '42?

A. There was no real estate involved in the transfer, as I recall. The real estate was acquired in 1943 in the names of all four partners. That is a matter of record in Fresno County.

Q. Have you changed your stationery to show that it isn't a sole proprietorship, Mr. Harkness?

A. We changed our stationery as soon as we got new stationery, but we continued to use up the old stationery in our files at that time until we could get the new stationery.

Q. The reason I asked, the stationery attached to Respondent's Exhibit M shows United Packing Company, Floyd J. Harkness, Owner. It was changed sometime after '44?

A. Is that an original letterhead or tissue copy?

Q. You will have to answer that question, I don't know.

A. That is a tissue copy. The original letterheads that went out to the business world were changed immediately.

Mr. Mather: That is all.



(Testimony of Floyd J. Harkness.)

The Court: Have you any redirect?

Mr. Ehrlich: Just a few questions, your Honor.

Redirect Examination

By Mr. Ehrlich:

Q. I introduced in evidence this morning, Mr. Harkness, a certificate of doing business under fictitious name. That was signed by all members of the partnership at the time you organized this partnership on January 1, 1943? A. It was.

Q. Now, that was published in a newspaper in Fresno County?

A. In the Daily Real Estate Reporter.

Q. And it was recorded as the document shows in the county records of the County Recorder?

A. It was.

Q. Mr. Harkness, I direct your attention to the partnership agreement dated December 31, 1942, and the provision with respect to the profits, distribution of profits. I am reading from Pages 3 and 4, Mr. Mather, part of the paragraph. It says:

“It is understood and agreed that first party is to receive for his said services a certain percentage of the net profits of said business to be agreed upon between all the partners herein from time to time as they may agree upon between themselves, and that the balance of the net income of said co-partnership shall be equally divided between all of the co-partners herein at such time or times as they may agree upon, provided, however, that any profits

(Testimony of Floyd J. Harkness.)

which third and fourth parties are entitled to receive shall be paid to first party and [87] applied by him first, to any payment which first party may have advanced to third and fourth parties together with interest thereon and the balance thereof, if any, shall be applied by first party in the payment of the promissory notes which the said third and fourth parties have executed in favor of said first party for the purchase price of their share in said co-partnership business.”

Was that followed out?           A. It was.

Q. And the profits which accrued were first applied to interest, and the balance to principal?

A. That's right.

Q. Did you have any understanding with your son that he was to have no personal liability on the note?           A. With my son?

Q. Yes.           A. No.

Q. He was required to pay the note independent of the profits and losses of the United Packing Company?           A. That's right.

Q. Did you have any understanding with your daughter that she was not to pay the note except out of profits?           A. I did not.

Q. So that irrespective of the destiny of the United Packing Company co-partnership your daughter and son-in-law [88] had personal liability on the note?           A. That's right.

Q. I direct your attention to the stipulation, Mr. Harkness, and in particular the year 1944, and I read this item—I am reading, Mr. Mather, from

(Testimony of Floyd J. Harkness.)

6-F, Page 1, year 1944: "Credit to increase capital to \$65,000, \$30,439.60; credit to increase capital to \$65,000, \$30,439.59."

That is under the capital account of Floyd J. Harkness, Sr., and Molly A. Harkness. Was that the contribution of yourself and your wife to the increase in the capital of the partnership in '44?

A. It was.

Q. And it is stipulated that this is a transcript of the books of account so that this increase was entered in the books of the co-partnership, your Honor.

Now, reading from Page 3 of Exhibit 6-F, it shows that as of December 31, 1947, you and Mrs. Harkness had as undistributed profits, \$385,367.58. That is correct, is it not? A. Yes, sir.

Q. I direct your attention to Page 4 of the stipulation, Floyd J. Harkness capital account, and I am reading from the year 1944, entry 1231, credit to increase capital, \$65,000, \$30,439.60. That was the contribution of your son, Floyd J. Harkness, Jr., to the capital account of the partnership in 1944, was it not? [89] A. Yes, sir.

Q. I direct your attention to 6-F, Page 5, still reading from the capital account of Floyd J. Harkness, Jr., which says, "Total capital 12/31/47, \$105,681.12."

That was the capital and undistributed profits of your son on the accounts of the United Packing Corporation, is that correct? A. That's right.

Q. I direct your attention to Exhibit 6-F, Page



(Testimony of Floyd J. Harkness.)

6. I am reading the year 1944, 12/31, and I am reading, by the way, from the capital accounts on the books of the corporation of William H. and Harriet Harkness Colgate, 12/31/44: "Credit to increase capital to \$65,000, \$30,439.60."

That was the amount that your daughter contributed on the books of the partnership to the partnership capital, is that correct?

A. That's right.

Q. I direct your attention to the same capital account of William H. and Harriet Harkness Colgate, Page 7, 6-F, "Total capital, 12/31/47, \$121,-650.11."

That is the total capital and undistributed profits credited to the credit of your son-in-law and your daughter on 12/31/47; is that correct?

A. Yes, sir.

Q. I direct your attention to the co-partnership agreement [90] of December 31, 1942, 11-K; attached to that exhibit is a financial statement which shows that the total capital of the co-partnership on 1/1/43 was the sum of \$138,241.61; is that correct?

A. Yes, sir.

Q. That is net after deducting certain liabilities which appear on this statement?

A. That's right.

Q. And the contributions by the partners to the capital were, F. J. Harkness, Sr., \$34,560.41; Mrs. Molly A. Harkness, Sr., \$34,560.40; Harriet Harkness Colgate, \$34,560.40; and F. J. Harkness, Jr., \$34,560.40.



(Testimony of Floyd J. Harkness.)

Is that correct?           A. Yes, sir.

Mr. Ehrlich: That is all.

Recross Examination

By Mr. Mather:

Q. Mr. Harkness, why, if all this property that you had was community property when the agreement of December 31, 1942, was entered into, were the notes, Petitioners' Exhibits 16 and 17, made payable to you instead of one to you and one to your wife?

A. Well, we were operating under the community property rights of the State of California. You had a tissue copy of one of our second sheets there that shows myself as owner of [91] the business, and regardless of the fact that I was owner of the business, she had her community interest in it.

Mr. Mather: That is all.

Mr. Ehrlich: Any questions, your Honor?

The Court: No questions.

That is all, Mr. Harkness.

(Witness excused.)

The Court: Call your next witness.

Mr. Ehrlich: Mrs. Colgate, please.

Whereupon

HARRIET HARKNESS COLGATE

was called as a witness on behalf of the Petitioners and having been first duly sworn, testified as follows:

Direct Examination

The Clerk: State your name and address, please.

The Witness: Harriet Harkness Colgate, 520 Eye Street, Sanger, Fresno County, California.

By Mr. Ehrlich:

Q. Mrs. Colgate, you are the daughter of Floyd and Molly Harkness? A. I am.

Q. Floyd, Jr., is your brother? A. He is.

Q. William Colgate is your husband?

A. He is. [92]

Q. How long have you lived in Fresno?

A. All my life, 28 years.

Q. You were temporarily absent during a portion of '42, '43, and '44? A. Yes, I was.

Q. What is your age, by the way? A. 28.

Q. When did you become of age?

A. September, '41.

Q. September, '41? A. Yes.

Q. When did you graduate from USC?

A. June, '42.

Q. When were you married?

A. August, '42.

Q. And you are the Harriet Harkness Colgate who signed the partnership agreement of December 31, 1942? A. I am.

(Testimony of Harriet Harkness Colgate.)

Q. Mrs. Colgate, where were you when you signed the partnership agreement, do you recall?

A. In Columbus, Ohio.

Q. With your husband?

A. Yes, with my husband.

Q. He was at a——

A. He was at Columbus Quartermaster Depot there on [93] orders.

Q. Where were you when you signed the certificate of doing business under fictitious name? You are familiar with the document I mean?

A. I was in Columbus.

Q. You know what the document is, you are familiar with the document—withdraw that question.

Referring to this document which I am handing you, Petitioners' Exhibit, certificate of co-partnership, is that your signature, Mrs. Colgate?

A. Yes, it is.

Q. Where were you when you signed the document?      A. Columbus, Ohio.

Q. The notary's certificate attached shows that it was notarized on the 28th of November of '42 in Franklin County, State of Ohio, acknowledged then.

Mrs. Colgate, during your childhood I assume you lived with your father and mother?

A. I did.

Q. How long a period of time did you live on the ranch outside of Fresno with them, about?

A. I believe about 10 years.

(Testimony of Harriet Harkness Colgate.)

Q. When did you first discuss with your parents, your father or mother, either one or both, this question of having an interest in the business which was being conducted by your [94] father under the fictitious name of United Packing Company?

A. Over a year before I signed it. It was something that had been talked in our family ever since I could understand the words "packing company," that someday we would be a part of United Packing Company.

Q. When you say "we," whom do you mean by "we"?

A. My brother and I.

Q. Those discussions had gone on periodically?

A. For years.

Q. With your father and mother and brother participating too?

A. Yes.

Q. And yourself?

A. Yes.

Q. Directing your attention to this document, Petitioners' Exhibit 11-K, which is the partnership agreement of December 31, 1942, when did these discussions crystallize? You said about a year prior to the time of signing.

A. Yes.

Q. You signed on December 31, or, you signed it in the autumn of 1942, around the end of the year?

A. Yes,

Q. You say you signed that sometime when? In the end of—

A. In November. [95]

Q. Don't be confused. I am talking now not about the certificate of doing business under ficti-



(Testimony of Harriet Harkness Colgate.)

tious name, but the partnership agreement. You signed it when?      A. In March.

Q. March?      A. '43.

Q. How long prior to the time you actually signed the partnership agreement, Petitioners' 11-K, did you have these discussions, to the best of your recollection?

A. Well, we discussed it.

Q. I say, when? Just answer when first.

A. Summer of 1942 and January of 1943.

Q. In the interim as well?      A. Yes.

Q. You were married in August of '42. Will you relate with whom you had your first discussions regarding the partnership agreement?

A. Well, we discussed it before I was married.

Q. Who is "we"?

A. My father, mother, and brother. Then after I was married——

Q. But nothing crystallized at that time, just family discussions about participation of you and your brother in the United Packing business?

A. Yes. [96]

Q. Then you said in August of '42, did you have further discussions after your marriage or before?      A. After our marriage.

Q. With whom were these discussions?

A. With my father and mother.

Q. Where were they?

A. They came back to Columbus, Ohio, in January of '43.

Q. You said you had some discussions in Au-

(Testimony of Harriet Harkness Colgate.)

gust of '42. Did you have any discussions then?

A. Yes, I was in Fresno.

Q. In August at the time of your marriage?

A. Before my marriage. I was married August 14.

Q. And you were in Fresno before that?

A. Yes.

Q. Had you discussed it with your father and mother? A. Yes, I had.

Q. Was your brother there or not?

A. No, he was in the Army.

Q. You don't recall seeing him at that time?

A. No, I did not.

Q. Did these discussions progress from August either conversationally or in writing between you and your parents? A. Yes, they did.

Q. When did you leave Fresno to join your husband? A. August 7, 1942. [97]

Q. You were married in Fresno?

A. No, I left Fresno August 7, 1942, and arrived in Petersburg, Virginia, I believe the 12th of August, and I was married on the 14th of August.

Q. In Petersburg, Virginia?

A. In Petersburg, Virginia.

Q. Where did you go from there?

A. We went to Columbus, Ohio.

Q. You and your husband?

A. Yes, on orders.

Q. How long were you stationed there?

(Testimony of Harriet Harkness Colgate.)

A. Approximately a year and a half.

Q. These discussions were with your parents while they were in Columbus, or as a result of correspondence between you?      A. Yes.

Q. And you signed the partnership in March, to the best of your recollection, March of '43, the certificate of doing business in November of '42.

By the way, did you receive any documents, did you receive what purported to be an agreement of partnership between your father, your mother, your brother, and yourself while you were in Columbus and prior to the end of December, '42?

A. I did.

Q. Did you examine that document? [98]

A. Yes, I did.

Q. Who sent you the document?

A. I believe it came from United Packing Company office in Fresno.

Q. Was it transmitted by your father to you?

A. Yes, it was.

Q. Was there a letter with it?      A. Yes.

Q. You haven't any of this correspondence, have you?

A. No, I haven't. We lived out of suit cases and in homes of other people, and we destroyed all our personal letters.

Q. You didn't keep any of the letters?

A. No.

Q. When you received this document—you haven't a copy of it any more, have you?

A. No, I don't.

(Testimony of Harriet Harkness Colgate.)

Q. Did you sign the document?

A. No, I did not.

Q. Did you have any objection to it?

A. Yes, there were several objections.

Q. What did you do? Did you convey those objections to your family? A. Yes, I did.

Q. Will you please explain to the Court just what you conveyed to your family and why you didn't sign the document? [99]

A. Well, there were several stipulations in it that I didn't agree to, and as my husband had signed the note with me, which made him as liable for this amount we borrowed, he and I discussed it, and we just didn't agree to them.

Q. Can you recall what you didn't agree to generally, not in detail, but generally so the Court may have that picture?

A. That my mother and father, Molly A. and Floyd Harkness, had too much power, and in case of death there were several stipulations that we didn't agree to.

Q. You wrote that to your family?

A. Yes, we did.

Q. Subsequently was a new document sent to you or did your father and mother bring you one, or what occurred?

A. I believe my mother and father came shortly after that, and we had a long discussion about it. In March, after lengthy correspondence about it, the document was sent in March which we did agree to.



(Testimony of Harriet Harkness Colgate.)

Q. And your father and mother called on you in January, '43?      A. Yes, January, '43.

Q. And you discussed the situation at that time. Was your husband present?

A. Yes, he was.

Q. You and your husband while you were at camp with him [100] continuously discussed these provisions which you felt weren't fair to you in view of your husband having assumed the liability on the Note?      A. Yes, we did.

Q. Subsequently, in March, a document was transmitted to you by mail, was it?

A. Yes, it was.

Q. That was satisfactory to you and you executed the document?      A. Yes, we did.

Q. Will you please tell us in more detail of the conversations which preceded the execution of the document? I refer particularly to discussions with your father particularly as to the reasons why you were to participate in the partnership and so forth. If you please, give the Court that picture of your relation with your father and mother with reference to the situation.

A. Well, as I said before, it had always been understood that if he gave one of his children the opportunity to make something, to make a venture, that he would give the other an opportunity. In the summer of '42 when all this was coming to a head about the co-partnership, we all had discussed my making a venture into some other business such

(Testimony of Harriet Harkness Colgate.)

as the di Giorgio Farms that were selling, I think, for \$6 a share, and also my husband, though I was engaged to him and knew I was going to [101] marry him, he had talked of maybe going into this Rapid Harvest. I could have invested into that or Standard Oil.

At the outcome of this discussion, since my husband was more interested in this type of fruit business, it was decided to take the risk of that note in with the United Packing Company.

Q. I direct your attention to this agreement, the supplemental agreement which was signed on the 4th day of January, 1943, Petitioners' 12-L, and ask you if that Harriet Harkness Colgate is your signature.      A. It is.

Q. This is the agreement under which your father received a salary of 75 per cent of the net income from United Packing up to the amount of \$100,000, and the other partners participated thereafter. Do you recall that document?

A. Yes, I do.

Q. Do you recall where you signed that?

A. Columbus, Ohio.

Q. Did you have any discussions with your father with reference to the salary which he was to receive?

A. Yes, we did, and my husband and I thought it was a just salary for his experience and being on the spot, and in a tight business like this during the war it took a long time to get letters back and forth, and his services were well worth that.

(Testimony of Harriet Harkness Colgate.)

Q. Were you interested, Mrs. Colgate, in having your husband become affiliated with this business?      A. Yes, I was.

Q. And you had discussed his future after he was retired from the Army with him on many occasions?      A. Very thoroughly.

Q. Did you have any discussions with your husband as to whether or not the funds necessary to make an investment in the co-partnership should come from any other source?

A. Yes, we did discuss that very thoroughly. My husband comes from a very wealthy family, and his father had told us that any venture that he might wish to take to get started into business, he would back him up 100 per cent.

We discussed that, but since I had already had this offer from my father to go into anything I wished, Standard Oil or anything, we decided to take that. We had legal counsel, and that was fine, so we took that.

Q. So you decided to borrow the money from your father?      A. From my father.

Q. Not from Mr. Colgate's family?

A. No.

Mr. Ehrlich: I am trying to touch just a few points, your Honor, not to delay this matter unduly.

The Court: When you speak of borrowing money, I suppose you mean you have reference to what this \$34,000 was given [103] for? There was no money actually borrowed.



(Testimony of Harriet Harkness Colgate.)

Mr. Ehrlich: That is correct. I meant the note, your Honor, the obligation.

The Court: One-fourth interest in the partnership.

Mr. Ehrlich: The creation of the one-fourth partnership by the giving of the note. I was a little loose in my language there, I am sorry.

Q. (By Mr. Ehrlich): The only time you worked in the offices of the United Packing Company was for three months, your father testified, around June of 1942? A. Yes.

Q. After you had graduated from college and before your marriage?

A. Yes, that is true. But at the time that this all occurred, my husband was in the Army, and at that time there were very few officers that stayed in this country more than six weeks after they received their commissions. At that time, the year and a half, I never unpacked my suitcase, always planning that the next day or week he would receive orders and I would be back at my job at the United Packing Company.

Mr. Ehrlich: That is all.

The Court: Cross-examine.

### Cross-Examination

By Mr. Mather: [104]

Q. You never did go back to your job at United Packing, did you?

A. No, I didn't. We have a son.



(Testimony of Harriet Harkness Colgate.)

Q. You spoke of investing your funds. What funds did you have in '42? A. This money.

Q. What money?

A. This promise that I took at his word that when he gave my brother an opportunity to make an investment, a risk, that he would give the same opportunity to me. If I had chosen to go to Rapid Harvest there would have been probably a check written; but since we chose, my husband and I, to go into this, there was no need.

Q. He never gave you any money at the time you executed the note, did he? A. No.

Q. You spoke of discussions that you had. Who were these discussions with?

A. What discussions do you mean?

Q. You spoke of discussions that you had about the creation of the partnership in 1942.

A. With my mother and my father.

Q. All right, just what was said and by whom?

A. It has been a long time and I can't remember the exact words at all. [105]

Q. If you will just come close.

A. Well, it was that it was the whole gist of what I have been saying.

Mr. Ehrlich: Well, repeat it. Mr. Mather is entitled to have your testimony.

A. (Continuing): Well, it was that I would borrow this money to purchase one-fourth interest in the United Packing Company; and with the understanding all along that my husband, as com-

(Testimony of Harriet Harkness Colgate.)

munity property, would be as liable as I and would ultimately come into active participation.

Q. (By Mr. Mather): That is the sum and substance of your conversations that you had in 1942?

A. Yes, that is the substance of it. It was always known that my brother would be given an opportunity to go into it. He worked in it ever since he was 15 and 16 years old.

Q. I think you testified that you didn't like the original document that was sent to you. Can you tell me any stipulation in that agreement, 11-K, that was put in there because of discussions you had with respect to the parts you didn't like in the first agreement?

A. Well, if I could find—it's in here that only two parties had to concur.

Q. Yes. A. And that was changed. [106]

Q. Is that the part you didn't like?

A. Yes, that is one of the parts.

Q. It wasn't changed until after '42, was it? It wasn't changed until the supplemental agreement sometime after '42 when your husband was taken in? A. I can't remember that.

Q. Well, now, give me another one.

A. Well, this part in here—I can't look through, but that we would get to purchase in case one of them passed away, the other interest.

Q. What part of that didn't you like?

A. Well, we just discused it and didn't agree to it.

(Testimony of Harriet Harkness Colgate.)

Q. What did you agree to?

A. In the stipulation?

Q. Well, what would be satisfactory to you about purchasing the interest if one person died?

A. Well, that we would—no one person would take over that whole part of it, we would have an equal division into it.

Q. Was the partnership agreement reformed in that respect? It is provided in the agreement, Mrs. Colgate, that if anybody wants to dispose of their interest they have to first offer it to the remaining partners? A. Yes.

Q. And that it will be sold to the remaining partners at book value? [107]

A. Uh huh (affirmative.)

Q. Now, that provision is in the instrument, isn't it? A. Yes.

Q. Is that the one you are referring to?

A. I believe so.

Q. The document that you have before you is purported to be a document as of December 31, 1942. Now, you didn't sign it until March of 1943?

A. March.

Q. I want to know if that document—do you know whether that document was signed by the other members in 1942?

A. I don't. I believe—I don't know, I am confused.

Q. You don't know whether it was or not?

A. I believe it was.

Mr. Ehrlich: Do you know?

(Testimony of Harriet Harkness Colgate.)

The Witness: I don't know, no.

Q. (By Mr. Mather): Do you know if there were any revisions in the document that was made in 1942 that was signed by the other members that you ultimately signed? A. Yes.

Q. Just what changes were made?

A. Well, the changes that I have said that we disagreed to.

Q. One is about if one of the parties died. I forget [108] just what you said with respect to that. Will you repeat it?

Mr. Ehrlich: The others should have a right to participate equally.

A. That no one person would be able to take over that fourth, that the other remaining, as it may be, the remaining three, would have a third of that one-fourth to them.

Q. (By Mr. Mather): What other provision?

A. About the concurring.

Q. Now, do you recall when you signed 12-L, that is about the salary?

A. What was your question again?

Q. Do you recall when you signed that?

A. You mean fixing Mr. Harkness'—

Q. When you put your signature. That shows that you signed your name down here.

A. This 31st day of December, '42.

Q. When did you sign this document?

A. I believe in November of '42.

Mr. Ehrlich: I think she is confused.



(Testimony of Harriet Harkness Colgate.)

Mr. Mather: I am trying to straighten her out if I can.

Q. (By Mr. Mather): This has to do with this partnership agreement about salaries that are to be paid to your father. [109]

A. That was in January.

Q. Well, the document is purported to be executed as of January 4, 1943, but you now tell me that you didn't like the agreement of partnership dated December 31, 1942, so you didn't sign it until March of 1943. What I am trying to find out is if you signed that supplemental agreement that is effective as of January 4, 1943, before or after you agreed to the articles of co-partnership that you didn't sign until March of '43.

A. I signed this before. We had so many discussions going back and forth in correspondence and such that I knew about this stipulation and I agreed to it before.

Q. Before you signed this partnership agreement?

A. Yes. It had been understood and talked about so much that I knew about that.

Q. Now, you aren't confused about another supplemental partnership agreement that was executed in 1945?

A. No.

Q. You remember that one, too?

A. Yes.

Q. That provided that three people could make changes?

A. Yes.

Mr. Mather: I think that is all.

The Court: Any further examination?

Mr. Ehrlich: No, thank you, your Honor. [110]

The Court: That is all.

(Witness excused.)

Mr. Ehrlich: Mr. Colgate, please.

Whereupon

WILLIAM HOYT COLGATE, JR.

was called as a witness on behalf of the Petitioners, and having been first duly sworn, testified as follows:

The Clerk: State your name and address, please.

The Witness: William Hoyt Colgate, Jr., 520 Eye Street, Sanger, Fresno County, Sanger, California.

### Direct Examination

By Mr. Ehrlich:

Q. Mr. Colgate, where do you reside?

A. 520 Eye Street, Sanger, California.

Q. How long have you resided in Fresno County.

A. Approximately 20 years.

Q. When did you go into the Army?

A. March 6, 1941.

Q. Under what circumstances?

A. Well, at that time I thought, and according to the papers and everything, that fellows going into the Army then would go in for one year, and after the termination of one year you would be discharged.

Q. So you enlisted; is that right?

A. So I enlisted. [111]

(Testimony of William Hoyt Colgate, Jr.)

Q. Where were you stationed at that time?

A. I was stationed at Monterey, California.

Q. Where else after that?

A. After that I went from there to Camp Roberts on orders, and from there I went to San Luis Obispo.

Q. Were you ever stationed outside the State of California?

A. Then I went to Ford Ord, and from Fort Ord in, I believe it was the middle part of May, 1942, I was sent to Camp Lee, Virginia, Petersburg, Virginia, on orders.

Q. How long did you remain there?

A. I left there in, I believe it was in October of 1942.

Q. Where did you go from there?

A. I was sent on orders to Columbus Quartermaster Depot, in Columbus.

Q. By the way, you enlisted as a private?

A. I did.

Q. Where did you go from Columbus, Ohio?

A. From Columbus, Ohio, I was sent, I believe it was in 1944, in March, I believe, I was sent to the Commander General Staff School, Fort Leavenworth, Kansas.

Q. How long did you stay there?

A. I stayed there until June, and from there I was sent back to Camp Lee, Virginia. [112]

Q. How long did you remain there?

A. I stayed there until August, when I was sent

(Testimony of William Hoyt Colgate, Jr.)  
to the Woodrow Wilson General Hospital at Stanton, Virginia.

Q. You became ill in the service?

A. Yes, I did.

Q. How long were you in the service?

A. A little over three and a half years.

Q. When were you discharged?

A. I was given orders to proceed home on terminal leave in October of 1944, and my terminal leave ended and I was retired in January, 1945.

Q. You received a medical discharge from the service?

A. I did, medical discharge.

Q. And you actually retired then in January, '45?

A. Yes.

Q. When you said you came home, did you mean you went to Fresno County?

A. To Fresno, yes.

Q. Harriet Colgate is your wife, is she not?

A. She is.

Q. Prior to your marriage, how long had you known your wife, approximately?

A. Since about 1937.

Q. By the way, at the time you retired you were medically discharged from the service, what was your rank? [113]

A. I was a captain.

Q. What branch?

A. Quartermaster Corps.

Q. When were you married, Mr. Colgate?

A. August 14, 1942.

Q. At Camp Lee, Petersburg, Virginia?

A. Petersburg, Virginia.



(Testimony of William Hoyt Colgate, Jr.)

Q. You and Mrs. Colgate reside in Sanger, Fresno County, at the present time?

A. We do.

Q. And Mr. Floyd Harkness, Sr., is your father-in-law, is he not? A. Yes.

Q. How long have you known Mr. Harkness?

A. Approximately nine years, I would say.

Q. And Mrs. Harkness is your mother-in-law, and you knew her approximately the same length of time? A. Same time.

Q. You were married in August of '42. Do you recall when you first discussed the formation of the partnership in which your wife became a quarter owner? I refer to the partnership between your father-in-law, mother-in-law, brother-in-law, and wife. A. Would you repeat that question?

Q. Do you remember when you had discussions concerning [114] that? A. Yes.

Q. When did you first discuss it with your wife?

A. Well, when she came back there and we got married, that was among the first things we started to discuss.

Q. Did she initiate the subject with you?

A. No, I had always—well, it came about that I had always been interested in agriculture and I always wanted to get into it. Then she brought up this opportunity that had been offered.

Q. What did she say to you at the time, in substance.

A. Well, in substance, she had been promised

(Testimony of William Hoyt Colgate, Jr.)

this, some money from her father, equal to whatever was given to her brother, and we could more or less invest that as we saw fit.

Q. Did you and Mrs. Colgate discuss this matter at length?      A. We did.

Q. The advisability of your wife going into the partnership with her father and mother and her brother?      A. We did.

Q. Can you give us some more of the details of the discussion that you had?

A. Well, I knew that when I got out of the Army that we would want to go into something, and the discussion more or [115] less was whether we at that time wanted to borrow that much money and go in debt for it or whether we should wait until I was retired from the Army.

Q. Were you familiar with the business conducted by your father-in-law?

A. I was familiar to the extent that I had always heard about him and the United Packing Company where I worked at Peerless Pump Company before I went into the Army.

Q. By the way, where did you go to school?

A. Fresno State College.

Q. Had you worked at the Peerless Pump Company during the periods that you——

A. I worked at Peerless Pump Company during two summers and then a period for about, I would say, nine months.

Q. After you quit college?

A. After I quit college, yes.

(Testimony of William Hoyt Colgate, Jr.)

Q. Did you discuss in these discussions with your wife—did the provisions of the proposed partnership agreement come up?

A. They did, definitely.

Q. And you knew, did you not, that in order for your wife to participate in the partnership it would be necessary for you to sign a promissory note?

A. I did, and at the time I didn't know whether to sign the note and go into debt to Mr. Harkness or borrow it [116] from my own father. After lengthy discussion between my wife and myself we decided that I might be going overseas and it might be best to borrow it from her father, which we did.

Q. Your wife has testified to certain provisions of the proposed partnership agreement which were objectionable to you and herself. Do you recall those discussions?

A. Well, I believe one of them was that in case of a death of one of the partners as it stood then the partnership would fall back to Mr. and Mrs. Harkness, which, in my position, in case it was my wife, wouldn't have been a very good move.

Q. That was objected to and finally straightened out in accordance with the existing contract?

A. That's right.

Q. Did you and your wife have any discussions regarding the policy of the partnership of allowing the profits to remain undistributed in the business?

A. Well, we had discussed that for some time,



(Testimony of William Hoyt Colgate, Jr.)

but—you mean increasing the capital of the company? We wanted to do that because heretofore every time Mr. Harkness hired a key man to take a district or something he would borrow or work on a percentage deal, and at the end of the year he would take his percentage and his salary and withdraw it from the company.

Q. And you were perfectly satisfied to sign commitments to the effect that the profits should remain in the business so [117] that the capital account could increase?

A. I was. I was in the Army and had no use for it.

Q. So as to permit the business to grow.

Mr. Mather: Now, Mr. Ehrlich——

Mr. Ehrlich: I am sorry, I withdraw that. I am sorry, your Honor.

Q. (By Mr. Ehrlich): Were there any discussions as to other possibilities of investment with your wife? A. Oh, definitely.

Q. Will you please give the Court the substance of those discussions?

A. Well, we discussed all kinds of investments, and I had an offer from the Rapid Harvest Company of when and if I ever got out of the Army that I could go to work there at a very good salary. And then also, with this money that she supposedly could borrow, whether we should invest in stock at that time or hold it or go into the United Packing Company, which we ultimately did.



(Testimony of William Hoyt Colgate, Jr.)

Q. You said you worked for the Peerless Pump Company. What was the nature of the activities that you engaged in while working for them?

A. Well, I started there as an apprentice and finally worked up to where I was allowed to go out and work with the crews. We traveled all over the San Joaquin Valley installing [118] pumps, and as far as agriculture is concerned we had to know what type of crop was going to be grown, what size pump to install, how big a head of water they wanted, which way the water would flow, and we had to know everything that the farmer was going to grow in regards to irrigation.

Q. And you lived there, you said, practically all your life?

A. I have; about 20 years, yes.

Q. You returned from the Army in October, '44, is that correct?

A. Yes, I did.

Q. When did you start working for United Packing, actively working as an employee?

A. Actively working, I think I was home, got my suitcase unpacked, and about four days I was on the road.

Q. When you say "on the road" you were working for—what was the nature of your work?

A. At that time Mr. Sorensen, that was right at the end of the 1944 season, and I believe we were in Emperors at the time, and just about three weeks to go—

Q. By "Emperors" you mean grapes?

A. Emperor grapes, yes. I traveled around with Mr. Sorensen for the remaining three or four

(Testimony of William Hoyt Colgate, Jr.)

weeks of the season until the packing house closed.

Q. Then you received some \$450 or thereabouts salary [119] for the work for those three months?

A. I did, after going with Mr. Sorensen for two or three weeks until he just about was through. I mean, he didn't come around the packing house any more. I went down to the ranches and worked on the ranches.

Q. Mr. Sorensen retired from United Packing in January of 1945, did he not?

A. He did, but he didn't come around the sheds much after the grape deal was over.

Q. I understand. Now, Mr. Colgate, you worked for United Packing in 1945, did you not?

A. I did.

Q. What arrangements were made for your compensation at the time?

A. At that time I believe we were under the Wage Stabilization Law or Order, whatever it was, that a field man was allowed \$250 a month, and I believe a small percentage, for which I agreed to work.

Q. By the way, I direct your attention to this agreement—did I give you the 1945 agreement?

Mr. Mather: It is attached to the stipulation.

Mr. Ehrlich: I don't seem to be able to place my hands on it.

Mr. Mather: It is attached to the stipulation, Exhibit 3-C.

Q. (By Mr. Ehrlich): I direct your attention

(Testimony of William Hoyt Colgate, Jr.)  
to Exhibit 3-C—no, that isn't it. I wanted the supplemental agreement of January.

I have a copy here. I direct your attention to a document entitled, "This supplemental agreement dated the 11th day of January, 1946," signed by, or purported to be signed by Floyd Harkness, Molly A. Harkness, Floyd Harkness, Jr., Harriet Harkness Colgate, and William H. Colgate, Jr. Do you recall that document?       A. I do.

Q. Will you relate to the Court the circumstances under which this agreement was signed? By the way, your Honor, this is the agreement where Colgate became formally a party of the partnership to participate with his wife as her husband, having a quarter interest.

Will you please relate the circumstances to the Court?

A. You mean the document, describe the document?

Q. No, relate the circumstances under which it was signed. Do you recall when it was signed?

I am sorry, your Honor, he became a partner on the 16th day of January, 1945, and I think that is in the stipulation.

Mr. Mather: Exhibit 8-H. [121]

Mr. Ehrlich: Exhibit 2-B, Mr. Mather. No, I will take it from the stipulation.

Q. (By Mr. Ehrlich): I am directing your attention to this supplemental agreement between your father, your mother, your brother-in-law, your wife, and yourself.



(Testimony of William Hoyt Colgate, Jr.)

Do you recall the circumstances under which this supplemental agreement was signed wherein and whereby you became a partner of the United Packing Company?

A. And I participated in my wife's one-fourth interest.

Q. That is correct. When was that signed? Do you remember? Around this date that it bears?

A. Let's see. That was signed, I believe, in January, 1945, I think.

Q. It bears the date of the 16th day of January, 1945. Did you do some work for the United Packing during January, 1945? A. I did.

Q. I mean during the year 1945.

A. I did.

Q. And you devoted your services exclusively to that?

A. Exclusively to the United Packing Company.

Q. You received for your services for that year some \$5,375, is that correct?

A. That's right. [122]

Q. And that was provided for in the supplemental agreement? A. That's right.

Q. Now, what did you do during the year 1945?

A. What did I do?

Q. Yes, what was the nature of your service?

A. Well, I was in complete charge of what we call the Sanger-Clovis—we didn't have the Parlier Shed then, the Sanger-Clovis areas. I was just General Manager of the whole show out there.

Q. Of that district?



(Testimony of William Hoyt Colgate, Jr.)

A. Of that district, hiring and firing, shipping the cars, and the complete run of the outfit.

Q. I direct your attention to an agreement dated the 11th day of January, 1946, signed by the members of the partnership, fixing the participations of the partners. Do you recall the execution of that agreement? A. Yes, I do.

Q. During the year 1946 you rendered services to the partnership? A. I did.

Q. What was the nature of the service you rendered? A. Exactly the same as in 1945.

Q. And your participation, your salary for the year 1946 was the sum of \$46,554.79? [123]

A. I believe that is correct.

Q. That was based on a percentage of the profits in that portion of the business in which you were active?

A. That's right, 25 per cent of the Clovis and Sanger deals.

Q. That is as appears in the contract which was signed by the members of the partnership?

A. 1946, right.

Q. I direct your attention to an agreement which was signed the 24th day of January, 1947, signed by the members of the partnership. A. Yes.

Q. Do you recall that? A. I do.

Q. And that in turn provided for the participation of your father-in-law, your brother-in-law, and yourself? A. That's right.

Q. What did you do that year?

A. Same thing.

(Testimony of William Hoyt Colgate, Jr.)

Q. Same type of work?

A. As in 1945 and 1946.

Q. 1947 now we are talking about.

A. And 1947.

Q. And you received, it appears in the stipulation, for your services, the sum of \$35,928.45. [124]

A. I believe that is right.

Q. That represents, as it calls for in the contract, your 25 per cent of the profits of the particular operation which you were managing?

A. Of the Clovis and Sanger Districts, yes.

Q. That is what you were managing for the partnership.

During the year '48 you worked for the United Packing?      A. Definitely.

Mr. Ehrlich: I think that is all.

The Court: Cross-examine.

### Cross-Examination

By Mr. Mather:

Q. Mr. Colgate, at the time you executed Petitioners' Exhibit No. 17, which is a promissory note, had you seen a financial statement of United Packing Company?

A. I didn't see it, but I had verbally been told what it was.

Q. You knew that their assets consisted of \$100,000 in cash, didn't you?

A. I believe it was \$130,000, some odd, yes.

(Testimony of William Hoyt Colgate, Jr.)

Q. Cash was \$100,000, and \$38,000 was other property.      A. That's right.

Q. Did you know what their income had been for the year 1942? [125]      A. I did.

Q. Around \$141,000?

A. Somewhere in there.

Q. It wasn't much of a decision on your part to take a 25 per cent interest by executing a note, was it?

Mr. Ehrlich: Isn't that an argument?

Mr. Mather: I am just asking him. You asked what his decision was. This is cross-examination.

A. No, it wasn't.

Q. (By Mr. Mather): You would be glad to enter into those agreements most any time, wouldn't you?

Mr. Ehrlich: Well, now, Mr. Mather, if they turned out as well as this one, I would say so.

A. Yes, I would.

Q. (By Mr. Mather): What was your position with the pump company in '41?

A. I guess you would call me an assistant foreman of one of the field crews.

Q. What was your approximate salary?

A. Well, it ranged between \$150 and \$200, because the crews worked by the hours, and it depends on whether we had a good week or it was a rainy day, or something like that, that we didn't work

Q. Was that company owned by some of your relatives?      A. No.

Q. You don't contend that you were a member

(Testimony of William Hoyt Colgate, Jr.)  
of this partnership in our taxable year 1943, do you, Mr. Colgate?

A. Well, I believe I was in a sense of the word.  
Mr. Mather: You think you were.

That is all.

Mr. Ehrlich: Nothing further.

The Court: We might take a recess.

(Short recess.)

The Court: Proceed, gentlemen.

Mr. Ehrlich: I have a couple of questions of the witness.

### Redirect Examination

By Mr. Ehrlich:

Q. Mr. Colgate, you testified that the original partnership agreement that was sent you was unsatisfactory for the reason that in the event of the death of a partner the interest went to the father or mother. Did you discuss that with counsel at camp?

A. I did.

Q. Do you remember the names of the attorneys you discussed it with? Were they in the service with you, by the way?

A. Yes, they were. They were officers. Robert Bechtol [127] from Lincoln, Nebraska, Donald Ziegel from Eaton, Ohio, and Olin K. Petefish, from Lawrence, Kansas.

Q. They were attorneys in civilian life?

A. Yes, they were.

Q. And you discussed this document with them?

A. I did.



(Testimony of William Hoyt Colgate, Jr.)

Q. And your wife also? A. Yes.

Mr. Ehrlich: That is all, your honor.

Mr. Mather: That is all.

The Court: That is all.

(Witness excused.)

Mr. Ehrlich: Mr. Harkness.

Whereupon

FLOYD JAMES HARKNESS, JR.

was called as a witness on behalf of the Petitioners,  
and having been first duly sworn, testified as follows:

The Clerk: State your name and address, please.

The Witness: Floyd James Harkness, Jr., 1904  
Harvard, Fresno, California.

Direct Examination

By Mr. Ehrlich:

Q. How long have you resided in Fresno County,  
Mr. Harkness?

A. All my life, approximately 31 years. [128]

Q. Floyd J. Harkness, Sr., is your father, and  
Molly Harkness is your mother? A. They are.

Q. Harriet is your sister? A. Yes, sir.

Q. William Colgate is your brother-in-law?

A. Yes, sir.

Q. You are familiar with the articles of co-part-  
nership that have been introduced in evidence, Peti-  
tioners' Exhibit 11-K? A. I am, sir.

Q. When did you graduate from college?

(Testimony of Floyd James Harkness, Jr.)

A. June, 1941.

Q. And you had been deferred by the draft board to permit you to complete your education?

A. I had.

Q. Upon graduation from college, what did you do?

A. I immediately went to work for the United Packing Company.

Q. Had you worked previously for the United Packing Company?

A. Yes, sir, on and off for almost eight years, I believe it is.

Q. It was organized in 1937?

A. Well, prior to that. [129]

Q. You had worked for the United Packing Company, consisting of your father and Mr. Jasper?

A. Mr. Jasper, yes, sir.

Q. And after your father and Jasper dissolved and your father conducted the business as co-proprietorship you worked for him?

A. Yes, right afterwards for a considerable length of time.

Q. As I understand it, in June, '37, after school was over, you worked for your father at that time.

A. Yes. I was going to Fresno State College, started my vacation in June of that year, and instead of going back to college courses that fall, I remained and worked with my father in the United Packing Company, handled several areas for him.

Q. Is it correct to state that you worked every

(Testimony of Floyd James Harkness, Jr.)

summer since '34 in the activities in which your father was interested?

A. Yes, sir. I worked a full three months every year.

Q. You worked three months every year?

A. Yes, sir.

Q. And in all phases of the operations?

A. Yes, sir.

Q. What did you do during that seven-months period between June, '37, and January, '38? [130]

A. I worked in the packing plants various capacities in various packing houses. I ended up running the Exeter packing shed in Tulare County where we packed Emperor grapes. But I believe we packed tomatoes that year, and I operated that. I believe that was the year.

Q. Were you compensated for your services?

A. Certainly, yes, sir.

Q. Directing your attention now to the year 1941, you say you worked the rest of that year after graduating from Fresno State College?

A. Yes, sir.

Q. You worked for United Packing?

A. Yes, sir.

Q. What did you do during that period until the end of the year?

A. I did a little of everything for the company that year, sir.

Q. You say "the company." You mean——

A. United Packing Company. The first operation was on the west side in Firebaugh, where we

(Testimony of Floyd James Harkness, Jr.)

were growing carrots and canteloupes. I did all the office work for the majority of it in Firebaugh besides supervising part of the growing.

When that deal was over I went into the grapes. The deals sort of coincide; one is over and then the other begins. [131]

Q. And you received a salary, and did you have a percentage deal?

A. Yes. All I could get was five per cent that year.

Q. What salary did you receive?

A. The same as, I beleive, several other of our field men, \$150 a month, I believe the figure was.

Q. And your participation, am I correct, was approximately—your five per cent participation in your share of the deal was about \$910.41?

A. I believe that figure is correct, sir.

Q. When did you enter into the service.

A. January 12, 1942.

Q. At the time you entered the service you had been deferred by the draft board on the ground that you were in an essential occupation?

A. I had been previously, yes, sir.

Q. Had you had any discussions with your father at the time you left college with reference to your going into business with him?

A. Yes, sir, I had.

Q. Will you please state the substance of those conversations to the Court?

A. I had asked immediately upon getting out of college and going back to work for the United



(Testimony of Floyd James Harkness, Jr.)

Packing Company, that I be given an opportunity of becoming a part owner of the company [132] at that time and sharing in the profits of the company. However, we had at that time—I say “we” because I have been associated with the company for all my life, I mean, heard of it and everything—we had working arrangements with our Sales Manager, Claude Steiger, field men all over the valley, for various percentage deals, and my dad just couldn’t see fit at that time to let me in for more than five per cent. There wouldn’t have been anything left for my mother and father.

Q. Did he tell you that at the time?

A. Yes, sir. We talked of that often because I not only was in the field, but put in a part of every day and evening in our offices at Fresno, and we discussed it quite often.

Q. When were you discharged from the service, Mr. Harkness?

A. I was released from active duty and went on terminal leave, I think it was about the 6th of January, 1946.

Q. You enlisted as a private? A. Yes, sir.

Q. What was your rank when you came out?

A. Major in the Air Corps, sir.

Q. How long were you in the United States while you were in the service? From when till when?

A. I was in the United States for approximately two [133] years, from January 12, ’42, the day I

(Testimony of Floyd James Harkness, Jr.)

enlisted, until I departed for overseas duty December 23, 1943.

Q. Where were you stationed the rest of the time?      A. India, China, and Burma, sir.

Q. You were in India, China, and Burma from December, '43, or thereabouts, until the end of 1945?

A. Just about two years, sir, and I returned from overseas duty in December, '45, took a couple of weeks in the mechanics of the Army to get me out.

Q. Upon your discharge from the Army you were in Fresno?      A. Repeat that, sir.

Q. When you were discharged from the Army you were in Fresno at the time, at the end of your terminal leave. You were in Fresno, as a matter of fact, from January, '46.

A. Yes. My terminal leave was from January until April, but all that time I was working for United Packing Company.

Q. As soon as you returned to Fresno you started working for United Packing immediately, is that correct?      A. Yes, sir.

Q. And you have worked for United Packing ever since?      A. Yes, sir.

Q. That includes '46, '47, and '48?

A. Includes up to the present time, sir. [134]

Q. Now, getting back to this conversation with your father, at the time you worked for him during June to December of 1941, he stated to you that he couldn't at that time permit you to participate. Did you have any conversations regarding your future

(Testimony of Floyd James Harkness, Jr.)

relations with the business operated by your father and mother?      A. Yes, sir.

Q. You did have some conversation about it?

A. Yes, sir.

Q. About when, during that period?

A. Yes, sir. I was living with them. I was unmarried, and I talked to them very often.

Q. About your future relations with the business?      A. Certainly.

Q. What was the substance of the conversations?

A. Well, inasmuch as most all of our field men were on a year-to-year basis, it was my understanding and a promise from my mother and father that at the conclusion of 1941 I would be allowed to purchase an interest in the United Packing Company, because my father and mother at that time could make other arrangements for the following year with the other employees, allowing larger percentage to be sold to me.

Q. I direct your attention to Petitioners' Exhibit 11-K, the partnership agreement of December 31, 1942. When did the ideas as to the signing of an agreement crystallize between you [135] and your father and mother?

A. Well, we had been talking for a long time of it, but the actual, as you say, "crystallization" occurred during the summer and early fall of '42.

Q. Where were you stationed at that time?

A. Over here in Marin County at Hamilton Field.

Q. How long were you at Hamilton Field?



(Testimony of Floyd James Harkness, Jr.)

A. Around 13 months.

Q. From when to when?

A. November, 1942, until I——

Q. Went overseas?

A. Departed, left there and flew to Miami, Florida, to go overseas.

Q. During that period you visited continuously in Fresno?      A. Yes, sir.

Q. You were there——

A. Not continuously, but frequently.

Q. Frequently you visited your family, and the discussion of these family affairs, participation in the business, took place, is that correct?

A. Yes, sir. I both visited with them and with the business. I mean, I was home during the shipping season.

Q. Did you participate at all in the business activities?

A. Not formally, but on just about every visit home I [136] was in the office and at the various packing plants and so forth.

Q. You talked to your dad about the conditions of the business?

A. Dad and our other employees, yes.

Q. That was while you were in the service?

A. Yes, sir.

The Court: That was in '42?

The Witness: That was in '43, sir.

The Court: '43?

The Witness: Yes, sir.

The Court: I thought he asked you about '42,



(Testimony of Floyd James Harkness, Jr.)

The Witness: Pardon, I understood that to be '43.

Q. (By Mr. Ehrlich): In '42, where were you?

A. In '42 after my enlistment I went to Shepherd Field, Texas, and then was transfered in March, I believe it was, to Fort Logan, Colorado. Then in May, I don't recall the exact date, I was transfered to Presque Isle, Maine, in the Air Transport Command up there, and then in August, I beleive it was, I was transfered to the Officer Candidate School in Miami Beach, Florida.

Q. Then——

A. Was commissioned in late October and was assigned to Hamilton Field.

Q. You say you came to Hamilton Field in December? [137]

A. No, in November.

Q. November of '42?

A. Yes. I had a few days travel time to spare, so I spent them at home, four or five days around the 8th or 9th of November until the 13th or 14th, some such date.

Q. You are familiar with this certificate of co-partnership, the articles of co-partnership, the certificate of co-partnership transacting business under fictitious name is dated the 12th day of November, 1942, and the acknowledgment of notary public indicates that it was signed by your father, your mother, and yourself on the 12th day of Nevember, 1942. Is that about right?

A. Yes, that's right. And I was in Fresno at

(Testimony of Floyd James Harkness, Jr.)

the time that was drawn by our attorney, and I signed it at that time.

Q. I direct your attention to Petitioners' Exhibit 11-K, partnership agreement dated December 31, 1942.

A. Yes.

Q. You are familiar with that document?

A. Yes, sir.

Q. Do you recall about when you signed that document, approximately?

A. It was around the end of the year.

Q. On one of your visits to Fresno, or was that sent to Hamilton Field? [138]

A. No, there was a couple of documents involved there. It was drawn first, and I had agreed to most all the terms of it; however, my sister and brother-in-law did not agree, and I believe it was a little after the first of the year, probably in February or along in there when it was finally drawn and actually acknowledged by signatures by all parties concerned, including my own.

Q. You don't recall whether you signed it in Fresno or Hamilton Field?

A. I believe in Fresno, sir.

Q. Directing your attention to the River Ranch, you are familiar with the ranch which the Sorensens and the United Packing acquired 50-50?

A. Very familiar with it, sir.

Q. That was acquired from—who was it acquired from? Do you remember the name of the individual?

A. Yes, F. Haranaga.

Q. He was a Japanese?

A. Yes, sir.

(Testimony of Floyd James Harkness, Jr.)

Q. Do you recall when that was acquired?

A. It was——

Q. The second day of February, 1943. I have the deed here. A. Yes, sir.

Q. Were you consulted about the acquisition of that? [139] A. Yes, I was.

Q. Who consulted you? A. My father.

Q. What was the nature of the discussion that you had with your father?

A. As to the advisability of buying it or not. He knew that I was familiar with the ranch and had been on it many times for five or six years prior to that time when he handled the crops from that ranch.

Q. You handled this?

A. United Packing Company. I am speaking of "we" as United Packing Company at that time.

Q. United Packing Company had been handling the produce grown on this ranch? A. Yes.

Q. That had been part of your functions while you had been active with United Packing?

A. Yes. I had been on the ranch and knew the crops and how valuable they were to the rounding out of our United Packing Company shipping program.

Q. And you testified and the Court properly corrected us that these activities which you have testified to, I mean your discussions with your family and visits to the office and to the packing plants, the operations of the United Packing Company occurred during your temporary stays in Fresno



(Testimony of Floyd James Harkness, Jr.)

while [140] you were on leave from Hamilton Field during the year 1943?

A. I did testify to that. That is a fact, sir.

Q. Those talks occurred during '43?

A. Yes, sir.

Q. For the 13 months while you were at Hamilton Field?

A. November to the following December, yes, sir.

Q. From November, '42, to December, '43, and just before you left for India?

A. That's right, sir.

Q. And you had similar conversations, as I understand, with your father about problems that arose in connection with the United Packing business activities during that particular time?

A. I did, quite extensively, yes, sir.

Q. When you were in Fresno, did you live at home? A. Yes, sir.

Q. By the way, at the time you entered into the service there was owing to you the sum of \$1,326.73 for part of the compensation you were entitled to as a result of your activities with your father's enterprise, is that correct, with United Packing?

A. Yes, sir.

Q. That was credited in the transaction whereby you acquired the one-quarter partnership interest under the partnership [141] agreement for \$34,500?

A. Well, mine was \$33,000 something, I believe.

Q. It was \$34,560.40 less this amount of \$1,326.73, which was credited to the original purchase price; is that correct? A. That is correct, sir.



(Testimony of Floyd James Harkness, Jr.)

Q. And you gave your father this note for—I am showing you Petitioners' Exhibit 16, promissory note for \$33,168.35?

A. Yes, that would be for the balance that I owed.

Q. To acquire the partnership interest, the other portion being paid by you by your father crediting—

A. The money I had left with the United Packing Company.

Q. Toward the purchase price of your interest in United Packing? A. That is correct, sir.

Q. At that time, Mr. Harkness, I mean during the year '42, you had engaged in several other deals where independent of the United Packing you had made approximately between \$4,000 and \$5,000; is that correct? A. That is correct, sir.

Q. Those were deals of similar character as those conducted by United Packing. I mean, they were fruit and vegetable deals, grape deals? [142]

A. Yes, it's the field with which I was familiar, and therefore I would invest in something I knew.

Q. Individually you invested in it?

A. Yes, sir.

Q. And as a result of those deals, you had a few thousand dollars independent resource, is that correct? A. Yes, sir.

Q. At this time you were not married, were you, Mr. Harkness? A. No, I was not, sir.

Q. You stated that you had no objection to the original contract as submitted.

(Testimony of Floyd James Harkness, Jr.)

A. No material objection. I appreciated my sister and brother-in-law's viewpoint on it, but I had agreed verbally that the articles of co-partnership were substantially what my ideas were, and what I understood all along.

Q. You didn't see your sister very often during that period, did you?

A. No, sir; I didn't see her at all, I don't believe.

Q. You didn't see her at all?

A. I didn't see her for a good many years right there at that time.

Q. During this period had you had any writings between you and your parents during the year '42 while you were away, with reference to the partnership? [143]

A. Yes, sir.

Q. Did you keep any of those letters?

A. No, sir.

Q. Discussing the various provisions and what was being considered, is that correct?

A. The letters and correspondence, yes, sir.

Q. Let me ask you this: when, in November of '42, you signed the certificate of doing business under fictitious name, Petitioners' 15, you were in Fresno, at that time you discussed at length and in minute detail the provisions of the contract, did you?

A. That is, the question was in November of '42? Yes, sir.

Q. Did they present you with a proposed draft at that time, do you remember?

A. I don't believe the final document had been

(Testimony of Floyd James Harkness, Jr.)

drawn, just substantially what we were going to include in it. I don't remember, I don't believe Mr. Hansen had drawn the document at that time, the final one.

Q. Where were you on or about January, 1945?

A. January of '45 I was in Bengal, India, sir.

Q. Had you previously to that time been consulted with respect to the participation of your brother-in-law in the United Packing Company?

A. Oh, yes, sir, by correspondence, and when I was in [144] Hamilton Field in '43 it was understood we understood that when he got out he was going into the company.

Q. And you were then aware of the fact that when he retired from the armed service that he would become a partner participating with your sister in a one-quarter interest? A. Yes, sir.

Q. Do you recall where that supplemental agreement of January, 1945, was signed, wherein and whereby Mr. Colgate became a member of the partnership? A. What was the question, sir?

Q. Do you remember where you signed that document, the document I am referring to, the agreement?

A. When my brother-in-law came in the business, is that the one you are speaking of, sir?

Q. Do you recall when you signed that? It is dated the 16th day of January, 1945.

A. Why, I signed that later, sometime after that particular date. It was mailed to me overseas inas-



(Testimony of Floyd James Harkness, Jr.)

much as it materially changed the partnership and they wanted me to actually approve any entry of a fifth party in the partnership.

Q. Where did you sign it, do you recall?

A. I signed it while I was in India, sir.

Q. This was sent to you and you signed this while you were in India, is that correct? [145]

A. Yes, sir, although I had left authority at home with my father that in any case that arose that he had my power of attorney in case it was needed in any emergency.

Q. But they sent that document to you and you signed it in India sometime after January 16, 1945?

A. Yes, sir.

Q. In a period of 30 or 60 days, would you say?

A. It took considerable time to get mail over and back, yes, sir.

Q. But within a reasonable time after that date?

A. Yes, sir.

Q. Mr. Harkness, I direct your attention to the year 1946. The stipulation indicates that you were—withdraw that.

I direct your attention to the year 1946. On the 11th day of January, the members of the partnership, which consisted of members of your immediate family—

A. Five of us, yes.

Q. —and your brother-in-law, executed an agreement dated the 11th day of January, 1946, which provided for the compensation which your father, your brother-in-law, and you were to receive. Do you recall that?

A. Yes, sir.



(Testimony of Floyd James Harkness, Jr.)

Q. When did you commence working for the United Packing Company after your discharge?

A. Immediately, sir.

Q. That is, in January, '46? A. Yes, sir.

Q. This agreement is dated the 11th day of January, 1946? A. Right after I returned.

Q. This agreement provides for a salary which you were to receive from the United Packing, does it not? A. Yes, sir.

Q. That was on a percentage basis?

A. Yes, sir. It was on the same basis that prior employees with the United Packing Company shared. I had taken the same percentage Mr. Steiger did.

Q. It appears here that that was 25 per cent.

A. Yes, sir.

Q. What did you do for United Packing? What were your duties during the year 1946?

A. I was General Assistant to my father in the over-all management of the entire business, and in particular handled three areas.

Q. What areas?

A. Madera County operation where we packed plums and nectarines and peaches, and actually grew some nectarines and peaches; and then the canteloupe shipping operation in Mendota, west of Fresno, and at the culmination of the canteloupe deal, [147] the Tulare County operation of the United Packing Company where we shipped grapes on into about Thanksgiving time.

Q. The stipulation sets forth that for your serv-

(Testimony of Floyd James Harkness, Jr.)

ices rendered to the United Packing Company during the year 1946 you received the sum as compensation of \$57,984.75; is that correct?

A. Yes, sir. It is 25 per cent of the net profits, I believe.

Q. I direct your attention to the year '47. You performed services for the United Packing?

A. Yes, sir.

Q. What was the character of the service?

A. I believe they corresponded just about exactly to '46.

Q. And you received in your participation—your salary was in the form of a participation in the net profits?

A. Yes, sir.

Q. The stipulation shows that for the year 1947 you received \$53,635.13; is that correct?

A. As my salary, yes, sir.

Q. As your salary. Now, you are still employed by the United Packing Company?

A. Yes, sir.

Q. And you worked during the entire year '48? What was the nature of your services? [148]

A. As Assistant General Manager.

Q. The same as presently?

A. The same, except we didn't have a Madera County operation this year, and instead went more extensively into Tulare County where we operated two packing plants there.

Q. Was your salary for services in the nature of participation?

A. For '48?

(Testimony of Floyd James Harkness, Jr.)

Q. Yes. A. It——

Q. It hasn't been decided yet?

A. Yes, it has. The books are being closed.

Q. You are getting participation in the profits?

A. Yes, sir.

Q. And your participation in the profits, I am talking about salary, I am not talking about your partnership interest, I am talking about payment to you for services rendered——

A. Yes, sir, of the net profit, yes, sir.

Q. And your father, likewise? A. Yes, sir.

Q. I direct your attention to the agreement of January 4, 1943, which is the document signed by the four members of your family, and fixing the compensation, among other things, of your father, at 75 per cent of the net income of the said [149] United Packing up to \$100,000, and then making distribution of the balance. A. Yes.

Q. Do you recall where you were when you signed this? A. That was when, sir?

Q. In January, 1943.

A. I was at Hamilton Field.

Q. Do you recall signing this document?

A. Yes, sir. I believe it was mailed to me and I returned it, although we had talked of it previously. That was just a formality of signing it at that time.

Q. You had talked it over previously with your father? A. Certainly.

Q. And your mother? A. Yes.



(Testimony of Floyd James Harkness, Jr.)

Q. And you agreed upon that as the compensation which your father should receive as provided in the agreement? A. Yes, sir.

Q. I direct your attention to your capital account, Mr. Harkness, and it appears in Exhibit 6-F, Page 4, that on your capital account there was in the year '44, December 31, the following item of credits to increase capital to \$65,000: \$30,439.60. You are familiar with the fact that you were increasing the capital of the partnership in order to aid——

A. That was our understanding all along, sir, that [150] when we had accumulated sufficient profits to increase the capital that we would.

Q. And the capital account indicates that during the years '43, '44, and '45 you withdrew very little if any funds whatsoever, and allowed those funds to accumulate with United Packing Company. Is that correct? A. Yes, sir.

Q. In the year 1946, upon your return, you made substantial withdrawals: May 28, Collector of Internal Revenue, \$41,423.52; May 28, for '44 tax, Collector of Internal Revenue, \$35,645.15; June 14, Collector of Internal Revenue, 1945 tax, \$28,654.87.

Then, other than those withdrawals, the capital account on the books of the partnership show that you have withdrawn very little funds.

A. That's right, except for the payment of income tax during '46. I had received a salary though, and used that.

Q. You mean salary from the government?



(Testimony of Floyd James Harkness, Jr.)

A. Oh, no, sir, '46. No, sir. You are speaking of '46, I believe.

Q. That's right, I am talking of the year '46. Up to that time you had withdrawn very little if any funds. In the year '46 you made these large withdrawals for income tax purposes on your return.

A. Yes, sir. [151]

Q. By the way, you made the statement, you say you received a salary in '46 of \$57,984.75.

A. That was the same salary that previous employees had received.

Q. I am asking that, and that was withdrawn by you?

A. Yes, sir.

Mr. Ehrlich: That is all.

### Cross-Examination

By Mr. Mather:

Q. Mr. Harkness, I am a little confused. I think you testified, as did some of the other witnesses, that you executed that agreement which is Exhibit 11-K on or about the date it bears, December 31, 1942.

Mr. Ehrlich: That is not his testimony.

The Witness: I was just going to say that, Mr. Ehrlich.

That is not what I testified, sir.

Q. (By Mr. Mather): When did you execute it?

A. Oh, as I said, probably in February of '43.

Q. February of '43?

A. I believe that was approximately the date. I don't recall the exact date of the instrument, sir.

(Testimony of Floyd James Harkness, Jr.)

Mr. Ehrlich: The notary's certificate attached says the 27th day of February. That is, the notary's certificate [152] as to the signatures of the Harknesses. And the Colgates' notary's certificate in Franklin County, State of Ohio, is the 10th of March, '43.

Mr. Mather: Well, now, does the exhibit before the Tax Court show these dates of acknowledgment?

Mr. Ehrlich: I don't think they do.

Mr. Mather: The reason I want to clear this up is because I was under the impression that they were executed on or about the dates they bear, and I want to find out how the daughter didn't agree to them and signed them at a later date, and what the changes are.

Mr. Ehrlich: If not, may we correct the record to substitute it?

The Court: Yes. The complete copy should include the notarial certificates.

Mr. Ehrlich: I am pretty sure they don't, your Honor.

Mr. Mather: Let it be stipulated then that the notarial seal on Exhibit 11-K shows the signature by Floyd J. Harkness, Molly A. Harkness, and Floyd James Harkness, Jr., to be on the 27th day of February, 1943, and that the signature of Harriet Harkness Colgate is on the 10th day of March, 1943.

Mr. Ehrlich: All right.

The Court: The record may show that as a stipulation [153] of the parties.

(Testimony of Floyd James Harkness, Jr.)

Q. (By Mr. Mather): Was this correspondence about the partnership agreement that you had with your father or mother, was that longhand correspondence or correspondence from United Packing Company, typewritten correspondence?

A. I don't believe it was officially United Packing Company correspondence. I was home at Christmas time in '42, spent Christmas with my parents, and we talked of it at length then.

Q. I am talking about correspondence.

A. I think most of it was in person, sir.

Q. Longhand rather than typed?

A. No, sir, in person, talking to my parents while I was in Fresno.

Q. You testified that you had considerable correspondence.

A. I did, sir, but during the fall of '42.

Q. I am asking, was that typewritten or longhand correspondence?

A. Well——

Q. Do you recall?

A. In the case of my father it would be typewritten, and my mother, it would be longhand, sir.

Q. Have you searched United Packing Company for any [154] of that correspondence?

A. Well, he wrote that at home in the evenings, I know, and he used my own typewriter to correspond with me from home. It was informal in nature, most of it, but it concerned our business association to a great extent.

Q. Most of the key employees that were em-



(Testimony of Floyd James Harkness, Jr.)

ployed by United Packing Company other than Sorensen were with them in 1946, weren't they?

A. Some of them were and some of them were not.

Q. Well, I am saying most of them.

A. No, I don't think the majority of them were.

Q. Well, have you looked at Exhibit——

A. During the war we had gone in with Mr. Mazzie down in Bakersfield and grown vegetables, potatoes and rutabagas and other things, and that deal, of course, had been terminated.

Q. Have you looked at Exhibit 5-A attached to the stipulation of facts showing the bonus paid in addition to regular monthly salaries to the employees?

A. By that identification I don't know what you are talking about, sir. I am fairly familiar with most all the percentage deals we have had with various employees, sir.

Mr. Mather: That is all.

The Court: That is all, Mr. Harkness.

(Witness excused.) [155]

The Court: Any other witnesses?

Mr. Ehrlich: None, your Honor.

The Court: Petitioners rest?

Mr. Ehrlich: Yes, your Honor.

The Court: Have you any evidence to offer?

Mr. Mather: No, your Honor.

The Court: Both parties rest.



You may have 45 days for simultaneous briefs, 20 days for answering briefs.

That concludes the hearing at this time.

(Whereupon, at 4:25 o'clock p.m., the hearing in the above-entitled matter was concluded.)

---

13 T. C. No. 129

The Tax Court of the United States

Docket Nos. 16407, 16408

MOLLY A. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

FLOYD J. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Promulgated December 22, 1949.

On the facts, held, that when sole proprietorship was converted into a family partnership in 1943, neither petitioners nor their son and daughter intended to join together in the present conduct of the business, and, therefore, the partnership was invalid for tax purposes in that year. *Commissioner v. Culbertson*, 337 U. S. 733.

PHILIP H. EHRLICH, ESQ.,

R. J. HECHT, ESQ.,

LE ROY H. GUNTHER, ESQ.,

For the petitioners.

T. M. MATHER, ESQ.,

For the respondent.

## FINDINGS OF FACT AND OPINION OF THE TAX COURT

The above-entitled cases were consolidated for hearing. Respondent determined a deficiency in the income tax liability of petitioner Floyd J. Harkness in the amount of \$65,367.27 for the calendar year 1943 and a deficiency in the income tax liability of petitioner Molly A. Harkness in the amount of \$64,781.64 for the same year. The only issue raised in this proceeding is whether a valid family partnership existed between petitioners and their children, Floyd J. Harkness, Jr., and Harriet H. Colgate in the operation of United Packing Co. in 1943.

### Findings of Fact.

Part of the facts were stipulated and are so found.

Petitioners, Floyd J. Harkness and Molly A. Harkness, are individuals residing in Fresno, California. They filed their separate income tax returns for 1943 with the collector of internal revenue for the first district of California. Peti-

tioners were married July 14, 1915, and have made their home in California ever since. They have two children, Floyd J. Harkness, Jr., and Harriet Harkness Colgate, born in 1918 and 1920, respectively.

Harkness, Sr., has been a grower and shipper of fruits and vegetables since 1918. Prior to 1937 he engaged in this occupation first as an employee of various concerns and then as a member of two successive partnerships operating under the name of United Packing Co. In January, 1937, Petitioner bought out his partner and commenced operating the business as a sole proprietorship under the same name. Molly Harkness, as his wife, owned the assets of the business in community with him. The company specialized in packing and shipping cantaloupes, carrots, peaches, plums, nectarines and grapes. Some commodities were raised by the company itself while others were bought from farmers on a cash basis. Still other produce was packed and shipped by the company on a commission basis. For the purposes of its business United Packing Co. operated ranches and packing houses, and manufactured and stocked packing materials. Its main office was located in Fresno, but its operations covered a large area in the San Joaquin Valley extending northward 138 miles to Lodi and southward 127 miles to Arvin. At the close of 1942 the gross proceeds and net income earned by United Packing Co. amounted to \$1,-468,119.64 and \$141,790.95, respectively.

During the years up to 1942 petitioners' two



children were occupied primarily in obtaining an education, though each performed some services in their father's business. Harkness, Jr., attended schools until June, 1941, when he graduated from college with a major in commerce. From 1934 until 1941 he worked in his father's business during summer vacations and in 1937 he quit school for six months to help his father launch the sole proprietorship. From June, 1941, until January, 1942, he devoted his full time as an employee of United Packing Co. working as a "regular field man" at a salary of \$150 per month plus a five per cent bonus of approximately \$910. During this six-months' period he also earned four to five thousand dollars in independent deals in the fruit and vegetable business. On January 12, 1942, he entered the United States Air Corps as a private. At the close of 1942 petitioners' son still had a credit on the books of the sole proprietorship of \$1,412.05 for prior services performed. He owned no substantial property outside of these earnings at that time.

Harriet Harkness finished her schooling in June, 1942, when she graduated from college. During summer vacations she had occasionally performed secretarial services in her father's business. Harriet worked full time as a secretary at United Packing Co. from June until August, 1942, at which time she married William H. Colgate, Jr., who was then serving in the United States Army. Following her marriage she spent her time housekeeping for her husband at various military posts in



the United States until October, 1944. She owned no significant amount of property at the time of her marriage.

Harriet's husband, William Colgate, had resided in Fresno County, California, all his youth and had been an acquaintance of the Harkness family for a number of years prior to his marriage in 1942. He attended college, majoring in commerce, and during summer vacations was employed by Peerless Pump Company, the largest supplier of irrigation pumps in the San Joaquin Valley. Colgate later quit school and worked full time for this company for nine months before enlisting in the United States Army in March, 1941. This was in keeping with his desire to devote his career to agricultural pursuits in the Valley. As an assistant foreman aiding in the installation of extensive irrigation systems, Colgate acquired considerable knowledge of the mechanics of irrigation. After his marriage to Harriet, they were stationed at Columbus, Ohio, during the latter part of 1942 and throughout 1943.

In the fall of 1942 Harkness, Sr., became convinced that it would be advantageous to convert the operation of his fruit packing and shipping business from a sole proprietorship to a partnership composed of his wife, himself and his two children in the coming year. Many reasons dictated that decision. Primarily he desired to obtain the services of his son and son-in-law in the business. He felt that as a result of their college education and the practical experience they had gained pur-

suing agricultural employment in the Valley that they would make skilled, competent supervisors capable of overseeing the widespread operations of the company. Secondly, from his experience in the fruit and vegetable packing industry, Harkness believed that it was essential to increase the capital investment in the company by allowing annual profits to remain in the business. This was necessary not only to permit payment of extensive operating expenses, to allow for expansion of company facilities and equipment and to develop new business, but also to meet the exigencies of bad crop years when the company's income declined drastically. Furthermore, in 1942 fruit packers were anticipating a decline in profits due to labor shortages, low transportation priorities for their produce, and the probability that prices would tumble as in World War I. These circumstances only increased the need for increasing the capital reserve of United Packing Co. Yet it had been Harkness' experience in past years that to hold qualified supervisory personnel it was necessary to pay them large bonuses or percentages of profits which they invariably withdrew from the business and often used to set themselves up in competition with him, thus draining the company's capital. He felt the only way to retain profits in the company was to bring into the business persons who felt as he did. Through long discussions with Harkness, Jr., and William Colgate petitioner knew that they agreed with him that only a reasonable amount of the profits should be withdrawn from United Packing

Co. and the rest of the net income should be allowed to accumulate in the business.

While Harkness, Sr. was well aware that neither Floyd, Jr., nor William Colgate would be available to serve United Packing Co. for the duration of the war and he would be the only active partner in the meantime, yet he desired them to acquire an interest in the company at this time to guarantee their future help in running the business after their release from the Army.

Furthermore, formation of the partnership accorded with the wish of Harkness, Sr., to give his children an opportunity to make good. Even when Floyd, Jr., was a boy he and his father planned for the day when the former would be a full-fledged partner. After graduation from college in 1941 Harkness, Jr., had pressed his father to give him the status of a partner in the business, and while Harkness, Sr., had too many financial commitments to do so in that year, yet he promised his son he would make provision for him to purchase an interest in the business. Now petitioner desired to fulfill that promise. It was long understood that if one child was given an opportunity to participate in the business, the other would be given an equal opportunity. Offering Harriet an opportunity to become a partner in his business not only fulfilled this pledge, but was a long step toward securing the eventual services of her husband which petitioner so greatly desired.

While Harkness, Sr., consulted a lawyer concerning the feasibility of converting his business into



a partnership and was thus aware of the tax saving possibilities inherent therein, yet this fact was only a secondary consideration with him, and he would have entered into this arrangement regardless thereof.

During the fall of 1942 Harkness, Sr., held lengthy conversations with his son, who was stationed at a nearby airfield, regarding the proposed partnership. Harkness, Jr. eagerly accepted the chance to buy an interest in United Packing Co. for this had been his great desire for many years and assured him of full participation in the business on his return from the service. Petitioners and young Harkness then definitely planned to convert the business into a partnership starting in 1943.

Over the same period of time Harkness, Sr. also corresponded with his daughter and offered her either the opportunity to invest in United Packing Co. or some other enterprise. Furthermore, it was understood that if she decided to come into her father's business, her husband, William Colgate, would be allowed to participate in the partnership following his release from the Army. Harriet and William Colgate debated at length whether it was advisable for her to buy an interest in her father's business or invest elsewhere. Finally Harriet exercised her option to procure an interest in United Packing Co. after her husband determined he wanted to be associated with United Packing Co. upon his return from the service.

Thus by November, 1942, petitioners and both their children generally agreed to the formation



of a partnership for the operation of United Packing Co. in the coming year, though the details of the partnership relationship had not been worked out. A "Certificate of Co-Partnership Transacting Business under Fictitious Name" was executed on November 12, 1942, which petitioners and young Harkness signed on that date and Harriet signed on November 28. It stated that the four were co-partners carrying on business under the name of United Packing Co. and that Harkness, Sr. was the general manager in full charge of all business operations. This certificate was published in a local paper and later filed with the county recorder of Fresno County.

On December 31, 1942, "Articles of Partnership," providing the detailed terms of the proposed partnership, were drafted and met the approval of all but Harriet Colgate, who refused to sign until provisions as to control of the business and as to purchase of a deceased partner's share were modified.

On January 1, 1943, petitioners transferred to United Packing Co., a partnership, most of the assets and some of the liabilities of United Packing Co., sole proprietorship, existing on December 31, 1942, resulting in a net worth of \$138,241.61 for the partnership on that date. Harkness, Jr. and Harriet Colgate each bought a one-fourth interest in the partnership for \$34,560.41, equivalent to one-fourth of its net worth. To pay Harkness, Sr. for his share in the partnership the son used \$1,392.05 of the credit he had earned as compensation for

prior services rendered the sole proprietorship and on January 2, 1943, signed a promissory note for the remaining \$33,168.35 with interest at four per cent per annum. Harriet Colgate purchased her partnership interest from her father with a promissory note dated January 2, 1943, for \$34,560.40 plus four per cent interest per annum. William Colgate joined her on the note as co-maker. No collateral was required on either note.

These transactions were reflected on the books of United Packing Co., co-partnership, as of January 1, 1943. It showed assets of \$142,861.03 and liabilities of \$4,619.92 and a net worth of \$138,241.61. Capital of the partnership was stated to be \$138,241.61 resulting from contributions of \$34,560.41 each from the three Harknesses and Harriet Colgate.

On January 4, 1943, pending acceptance by Harriet Colgate of the articles of partnership drafted on December 31, 1942, Harkness, Sr., Molly Harkness, Harkness, Jr., and Harriet Colgate signed a supplemental agreement fixing compensation and distribution of partnership profits among the partners. The salary of Harkness, Sr., as general manager of the partnership, was fixed at 75 per cent of the first \$100,000 of the partnership net income. There was no provision for salaries for the other partners. The remainder of the first \$100,000 of partnership net income was to be divided equally among the partners, as were any profits over that amount. Paragraph three of this supplemental agreement stated:

It is understood and agreed that the payment of the 75% of the net income as provided for, is being made to first party on account of the fact that he is the only active co-partner in said business at this particular time and will continue as such during the duration of the present war.

During January, 1943, Harkness, Sr. discussed with the Colgates the modifications sought by Harriet Colgate in the partnership agreement drafted on December 31, 1942. Harriet withdrew her objections when the original draft was altered to meet her demands. The reformed partnership agreement was signed by the three Harknesses on February 27, 1943, and by Harriet Colgate on March 10, 1943. The terms of this agreement were as follows:

These Articles of Co-Partnership, made and entered into this 31st day of December, 1942, by and between Floyd J. Harkness, first party, Molly A. Harkness, second party, Floyd James Harkness, Jr., third party, and Harriet Harkness Colgate, fourth party, the first, second and third parties being residents of the County of Fresno, State of California, and fourth party being a resident of Columbus, Franklin County, Ohio:

Witnesseth:

That the said parties hereto for themselves, their heirs, executors, administrators and assigns agree to become co-partners in the business of carrying on a general business of growing, packing, shipping



and distributing of fresh fruit and vegetables in the State of California, including the purchasing and selling of any and all kinds of real and personal property necessary in carrying on and conducting said business, and said business shall be conducted under the firm name and style of "United Packing Co." from January 1st, 1943 until such time as the said co-partners shall mutually agree to dissolve said co-partnership, or the said co-partnership shall be otherwise as hereinafter provided dissolved, and that the terms upon which the said parties have entered into said co-partnership are hereinafter stated as follows, to-wit:

That the said business of growing, packing, shipping and distributing of fresh fruit and vegetables and any other business which shall be incidental and necessary thereto, shall be carried on in the State of California and that the principal place of business of said co-partnership shall be in the Rowell Building in the City of Fresno, County of Fresno, State of California or at any other place or places as the partners shall hereafter determine and that the firm name and style of said co-partnership business shall be United Packing Co., with real and personal property belonging thereto located in the Counties of Kern, Tulare, San Joaquin and Fresno, State of California.

It is understood and agreed by and between the parties hereto that said first party has been conducting the above mentioned business individually under the firm name and style of United Packing Co., and that he and Molly A. Harkness, his wife,



second party herein, have been the owners of all the real and personal property, equipment and materials that are now used in carrying on said business, together with such moneys as may now be on deposit in the name of the said United Packing Co. and together with any and all outstanding accounts owing as of this date, the said Floyd J. Harkness and Molly A. Harkness, first and second parties herein, do by these presents, sell, convey and set over, an undivided one-fourth partnership interest in and to all of the partnership property of the United Packing Co. to each of the third and fourth parties, namely, Floyd James Harkness, Jr., and Harriet Harkness Colgate, and from this date on each of the said co-partners above named, shall be and become the owners of an undivided one-fourth interest of all of the property of the said co-partnership doing business under the firm name and style of United Packing Co. and that the real and personal property which shall compose the capital of the said co-partnership and belong to the newly organized co-partnership is described in a Schedule marked Exhibit "A" and attached hereto and made a part of this agreement as if herein fully set out, and that there shall also belong to said co-partnership any and all other assets which now belong to said co-partnership and are not herein described as well as any and all other assets which may hereafter belong to said co-partnership; that all thereof shall belong equally to all of the partners herein named and in consideration of said first party conveying all of said real and personal prop-

erty to said co-partners being conducted under the firm name and style of the United Packing Co., and which is agreed to be of the net value of \$138,-241.61, that the said third and fourth party shall each execute in favor of first party a promissory note in the sum of \$34,560.40, payable in the manner as therein set forth to first party, and which sum shall be the purchase price for their undivided one-fourth interest in and to all of the assets of said co-partnership.

It is understood and agreed by and between the parties hereto that the said first and second parties are husband and wife and that all of the property which said first party is on this date conveying to the newly formed co-partnership, in which all of the above named parties are equal partners, has been accumulated by first and second parties during their married life and is the community property of first and second parties and that one-half thereof, by reason thereof, is the property of said second party and that the said second party does herewith join first party in the conveying of all of the said assets herein described to the said co-partnership so that from this date on, all of the said property now belonging to the said United Packing Co. and any and all other property which may hereafter belong to said co-partnership shall be owned equally by all the said co-partners.

It is understood and agreed by and between the said co-partners that said first party shall be, and is from this date on made the general manager of said co-partnership, and that he shall be in full

charge of all business operations of said co-partnership and that he shall have the full right to conduct the business of said co-partnership in such manner as he may desire, including the selling of any and all of the partnership assets and the purchasing of such other property as he may desire in the name of said co-partnership together with the right to borrow such money as he may deem necessary to carry on said business and in consideration thereof it is understood and agreed that first party is to receive for his said services a certain percentage of the net profits of said business to be agreed upon between all of the partners herein from time to time as they may agree upon between themselves, and that the balance of the net income of said co-partnership shall be equally divided between all of the co-partners herein at such time or times as they may agree upon, provided however that any profits which third and fourth parties are entitled to receive shall be paid to first party and applied by him first, to any payment which first party may have advanced to third and fourth parties, together with interest thereon and the balance thereof, if any, shall be applied by first party in the payment of the promissory notes which the said third and fourth parties have executed in favor of first party for the purchase price of their share in said co-partnership business.

It is understood and agreed that the said first party as general manager, and anyone of the other co-partners acting together shall have the right to bind the said co-partnership in such manner or



form as they may deem necessary, in order to carry on the business of the said co-partnership, and that no other co-partner shall have the right to in any manner bind the said co-partnership, and that no co-partner shall have the right to in any way sell, assign, set over, transfer or hypothecate his undivided one-fourth interest in said co-partnership without first obtaining the written consent of two other co-partners.

It is understood and agreed that said first party as general manager of said co-partnership shall devote such portion of his time and attention to the conducting and carrying on of said business, as he shall deem necessary and proper but that he will at all times use his own good judgment and best efforts and experience in carrying on said business for the best interests of all parties concerned and that second, third and fourth parties shall not devote any time or attention in carrying on said business unless hereafter agreed upon by and between any three of said co-partners and at that time it shall be agreed upon by and between any three of said partners as to what the compensation shall be for the services which third or fourth partner may contribute towards the carrying on of said co-partnership business.

It is understood and agreed that there shall be kept at all times a complete set of books of account wherein there shall be entered any and all records and transactions of said business and that the said first party shall have complete charge thereof and that said books shall be under his immediate super-



vision and that the said first party shall have the full charge of the collections and expenditures of all of the moneys received and taken in, in the carrying on of said business, and that all of the business transactions of said first party in carrying on said business shall be binding on all of the said co-partners.

It is understood and agreed in this connection that first party will render on the 1st of each year a true and full statement and account of the profits or losses of said business and all other matters and transactions done and performed in connection with said business.

It is understood and agreed by and between the parties hereto that upon the consent of the managing partner and two of the remaining partners that the capital of the partnership may be increased to such sum as may be determined by them, and that thereafter each of the partners shall contribute their respective share of the capital increase. In the event the managing partner and two of the other partners desire to reduce the capital of the partnership or withdraw profits, then such determination shall become binding upon all the partners hereto.

It is further understood and agreed by and between the parties hereto that each one of the partners will not, without the previous consent in writing of the other partners, enter into any bond or become bail or security for any person or persons or do or suffer to be done anything whereby the capital or property of the co-partnership may be taken by execution and that each partner shall

punctually pay his own separate debts and should anyone of the said co-partners become financially involved in outside interests so that his share in the said co-partnership business shall become involved, and should anyone of said co-partners in any manner so become involved then the other co-partners shall have the right to acquire such insolvent partner's right, title and interest in said co-partnership at the book value thereof without any consideration of the good will of the said co-partnership and upon such transfer, such insolvent partner shall have no further right, title and interest in and to the capital assets of the said co-partnership.

It is understood and agreed that in the event that anyone of the said co-partners decide to sell or in any way dispose of their interest in the said co-partnership business, that then the remaining co-partners shall have the right to purchase such partner's interest in said co-partnership and then the selling co-partner shall convey all of his right, title and interest in and to the said co-partnership property to the remaining co-partners, and shall receive for such conveyed interest the book value of such interest at said time without any consideration of the goodwill of the co-partnership and that the amount which the selling co-partner shall receive may be paid in cash by the remaining co-partners, but if the remaining co-partners do not desire to pay cash for the selling partner's interest, then they shall have the right to pay such amount by the application of the profits from the business

of such selling partner's share and that the same shall continue to be paid in this manner until the said purchase price of such selling partner's interest in said co-partnership shall have been paid in full, and then such selling partner shall execute in favor of the remaining co-partners a Bill of Sale conveying all of his right, title and interest in and to the said co-partnership and assets to the remaining co-partners.

It is understood and agreed by and between the parties hereto that should anyone of the partners become deceased, that then the remaining co-partners shall have the right to purchase such deceased partner's share in said business at the book value at the time of the death of such co-partner without any consideration of the goodwill of the partnership and such deceased partner's interest in said business shall be paid to the legal representative of such deceased partner and then the legal representative of such deceased partner's estate shall convey all of the deceased partner's right, title and interest in and to the said co-partnership property to the remaining co-partners and the legal representative of such deceased partner shall receive for such conveyed interest the purchase price for such deceased partner's interest which may be paid in cash by the remaining co-partners or if the remaining partners do not desire to pay cash for such deceased partner's interest, then they shall have the right to pay such amount by the application of the profits from the business of such deceased partner's interest and that this method of payment shall



continue until the said purchase price of said deceased partner's interest shall have been paid in full and that upon such payment in full of the purchase price of said deceased partner's interest in said co-partnership the legal representative of such deceased partner shall execute and deliver to the remaining co-partners a Bill of Sale conveying all of the said deceased partner's interest in the said co-partnership business and assets.

It is also agreed by the co-partners that in the event of any misunderstanding between the co-partners concerning the matter of conducting and carrying on of said business that then the partners shall, between themselves adjust the same; it is however understood in this connection that the decision of the general manager and one other partner hereto shall determine any question which may arise between them and in the event that anyone or more of said co-partners should be dissatisfied with such decision then they shall have the right as given them by the laws of the State of California to bring proceedings in court for the purpose of either dissolving the said co-partnership or obtaining such relief as they are entitled under the terms of this co-partnership.

It is further understood and agreed that this co-partnership business is entered into on the proposition that each partner has an equal interest therein and is entitled to an equal share in all gains, profits and increases which shall come, grow or arise from, or by means of said business so long as such partner or partners shall not be in default



in any of the terms of this agreement and that each partner shall be entitled to his one-fourth share of the said profits and that each partner shall likewise share equally in any losses which the said partnership may sustain and that each partner shall in the event it becomes necessary to furnish additional funds by reason of any losses which the said partnership may sustain, then each partner shall furnish and pay into the said business his equal share which may be necessary in order to continue on with the said co-partnership business. It being agreed that the decision of the managing partner and any two of the remaining partners shall be final as to the matter of the division of the profits and the amount which may be paid in by each partner in the event it becomes necessary to do so on account of losses sustained by the said co-partnership. ,

That at the end or sooner determination of their co-partnership, the said co-partners, each to the other, shall and will make a true, just and final accounting of all things relating to their said business, and in all things truly adjust the same; and that all and every stock and stocks, as well as the gains and increase thereof, which shall appear to be remaining, either in money, goods, wares, fixtures, debts or otherwise, shall be divided between them, share and share alike.

In Witnesseth Whereof, the above-named partners have hereunto set their hands and signatures the day and year first above written.

In February, 1943, an undivided one-half interest in a 300-acre vineyard and orchard was acquired

by Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate as tenants in common. The other half interest in the ranch was acquired by Chris Sorenson and his wife. Sorenson was a supervisory employee of United Packing Co. All funds for purchase of the vineyard were supplied by United Packing Co. and the amount loaned to Sorenson was repaid to the company by him. The 50 per cent interest acquired by the Harknesses and Harriet Colgate was included as an asset of United Packing Co. and subsequent income therefrom was included in its net income. Previously on January 16, 1943, by a bill of sale the personal property on the River Ranch had been conveyed to Chris A. Sorenson and Katharine Sorenson, his wife, and "Floyd J. Hartness, Molly A. Harkness, Harriet Harkness Colgate and Floyd J. Harness, Jr., co-partners, doing business under the firm name and style of United Packing Co., a co-partnership." Prior to these purchases, all the partners were consulted with respect to them, and Harkness, Jr., who was familiar with the land, approved the transactions.

During the year 1943 there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr. Harriet and William Colgate were absent from Fresno until his discharge from the armed services in October, 1944, so consequently she performed no services for United Packing Co. during the year 1943 nor did she participate in the management of its affairs. Throughout the year 1943 until December, Harkness, Jr. was stationed at

Hamilton Field, California, approximately six hours traveling time from Fresno, and frequently visited the company's office and packing plants on week-ends. While he was unable to participate in the business activities, yet he discussed its problems with his father on these occasions. In December, 1943, Harkness, Jr. went overseas with the Air Corps and did not return to Fresno until January, 1946.

In 1943 United Packing Co. earned gross proceeds of \$2,572,905.53 and a net income of \$361,582. In accordance with the terms of the supplemental agreement Harkness, Sr., was paid a salary of \$75,000 and Harkness, Sr., Molly Harkness, Harkness, Jr., and Harriet Colgate each were credited with \$71,645.50 as their respective shares of the profits.

Harriet's credit on the partnership books was first applied to pay off the principal and interest on her promissory note to Harkness, Sr., in the amount of \$35,942.82, and to offset prior withdrawals from her capital account consisting of cash in the amount of \$112.97 and sums of \$1,070.89 and \$31,423.67 paid to the collector of internal revenue. The balance of \$3,095.15 which she left in the business at the close of 1943 was withdrawn in 1944 to pay for taxes and personal expenditures. Of the \$71,645.50 credited to Harkness, Jr., \$34,495.08 was turned over to his father to pay the principal and interest on his promissory note. Of the remaining \$37,150.42 which he left in the business in 1943, young Harkness expended \$331.58 for his own use in 1944.

United Packing Co. filed a partnership return



for the year 1943, reporting a net income of \$361,582, compensation of \$75,000 paid to Harkness, Sr., and the distribution of \$71,645.59 from profits to each of the three Harknesses and to Harriet Colgate.

Harkness, Sr., and Molly Harkness filed separate income tax returns in 1943. As residents of a community property state each reported one-half of the total income of \$218,291 they together received from United Packing Co. in 1943, or \$109,145.50.

In his notices of deficiency sent to petitioners respondent determined that the net income of United Packing Co. for 1943 was \$361,823 and that each petitioner realized one-half of this amount, or \$180,916, as community property income. The notice of deficiency sent to Harkness, Sr. Stated in part:

(a) On December 31, 1942, you and your wife Molly A. Harkness, together with your two children, Floyd James Harkness, Jr., and Harriet Harkness Colgate, executed an instrument purporting to create a family partnership. Since Floyd James Harkness, Jr., and Harriet Harkness Colgate contributed no capital originating with themselves, rendered no services to the business, and were not required to participate in the control and management of the business under the terms of the alleged partnership agreement, it is held that they did not acquire valid partnership interests in the United Packing Company. Accordingly, profits from the above-named organization are reallocated to you and your wife on a community property basis, thus increasing your taxable income by \$71,770.50 as shown below.



Total net profit of United Packing

Company .....	\$361,832.00
Your community one-half share .....	180,916.00
Amount reported on return .....	109,145.50

---

Adjustment—Increase .....\$ 71,770.50

Similar language was contained in the notice of deficiency received by Molly Harkness.

The three Harknesses and Harriet Colgate had no intent to join together in conducting the business of United Packing Co. as bona fide partners in 1943 and thus their partnership was not valid for tax purposes in that year.

### Opinion.

Hill, Judge:

The only question for our determination in this case is whether a partnership, valid for tax purposes, existed between petitioners and their children, Harkness, Jr., and Harriet Colgate, in 1943. Petitioners contend that a valid partnership was formed between petitioners and their children on January 1, 1943, for the conduct of business under the name of United Packing Co. which continued in existence throughout the year. There is no contention on their part that William Colgate was a partner during this period. Respondent argues that all the net income of United Packing Co. in 1943 was community income of petitioners because no bona fide partnership existed in that year. Since this case arises in a community property state, California, and there is no serious contention denying the wife's

interest in United Packing Co., our consideration is directed to the alleged participation of the children in the business as partners.

In determining whether a bona fide partnership existed between the three Harknesses and Harriet Colgate in 1943 the basic question is, as the Supreme Court stated in *Commissioner v. Culbertson*, 337 U. S. 733,

\* \* \* whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the *present conduct* of the enterprise. (Italics supplied)

While some of the evidence in this proceeding is indicative of a valid family partnership yet, after careful study of the purposes which motivated the formation of a partnership for the conduct of United Packing Co., the circumstances existing at the time of this decision, the partnership agreement and the supplementary agreement thereto, and the actual conduct of the business throughout the year 1943, we are convinced that there was no intent on the part of the four alleged partners to join together

in the present conduct of United Packing Co. in 1943.

Both the purposes stated by Harkness, Sr., for converting the sole proprietorship into a partnership and the circumstances existing at the time of this decision in the fall of 1942 plainly show it was not contemplated by any of the parties that the Harkness children would contribute substantial capital or vital services to conduct of the business in 1943 or play any active part in its management. The evidence is clear that Harkness, Sr., offered his son and daughter an opportunity to acquire an interest in United Packing Co. in 1943 primarily to obtain the future services of his son and his son-in-law, William Colgate. He did not thereby expect to acquire either capital or services from Harriet at any time but wished to provide her with an opportunity for investment and lay the foundation for future participation in the company's affairs by her husband. His testimony shows that the year 1943 was chosen for conversion of the sole proprietorship into a partnership in order to guarantee the services of young Harkness and William Colgate after their return from the war rather than to secure their present services.

Q. You knew at the time you organized the company both your son and son-in-law were in the service, and you knew, naturally, that they couldn't render any service at the time. Why did you create the partnership knowing



that they could not render any service until they were released from the Army?

A. I wanted to be sure of their services \* \* \*

The circumstances existing in the fall of 1942 also makes it obvious that no vital services or contributions of original capital could have been expected from the Harkness children in 1943. Harkness, Jr., had been in the Army since January 1942, and there was little likelihood of his return to Fresno for the duration of the war. He owned no substantial property at this time and his prospective earnings were low while in the Army. Harriet had left California to accompany her husband across the country in his various stateside Army assignments in August 1942, and there was no certainty when he would be released. At the time of her marriage she had no independent means of her own and the evidence does not reveal the capital resources of her husband.

In keeping with economic status, neither Harkness child made any substantial contribution of new capital to United Packing Co. when the partnership was formed in 1943. Harriet acquired her one-fourth interest in the partnership solely by means of a promissory note which was paid entirely out of the company's profits accruing from the business at the close of the year. Young Harkness gained his interest in United Packing Co. by using a credit of \$1,392.05 owed him by his father for prior services and by signing a promissory note for \$33,168.35 which was also paid out of company earnings



for 1943. Since this credit was but a tiny fraction of the company's total capital of \$138,241.61 on January 1943, we must conclude that neither Harkness, Jr., nor Harriet Colgate contributed any substantial capital not already available to the company within the meaning of *Lusthaus v. Commissioner*, 327 U. S. 293. While such lack of a capital contribution originating with themselves is not in itself determinative of the partnership status of the Harkness children, yet the presence or absence of such a capital contribution is a significant test of whether the parties intended to form a bona fide partnership. *Lusthaus v. Commissioner*, *supra*, *Commissioner v. Tower*, 327 U. S. 280.

Turning to the partnership agreement, it also refutes an intent by the signatories to join together in the present conduct of the affairs of United Packing Co. but rather shows an intent that Harkness, Sr. continue to control the conduct of the business as in prior years when he was sole proprietor. The parties therein agreed that neither Harriet, young Harkness nor Molly Harkness would devote any time to carrying on the business unless hereafter agreed upon, but that Harkness, Sr. would be general manager thereof in full charge of all business operations which he might conduct as he chose. Harkness was given full charge of the books of account of the partnership and of the collection and expenditures of money taken in. His consent was necessary to bind the partnership in any business transaction and to lower or raise partnership

capital. His participation was necessary in the adjustment of any misunderstanding between the partners as to the conduct of the business and in the determination of the proper allocation of profits and losses among the partners. Furthermore, the Harkness children had no unhampered enjoyment of their share of the profits, for net income accruing to them was first to be turned over to Harkness, Sr. and applied to any payments he may have advanced to them and the balance was then to be applied on the promissory notes executed in his favor. Thus by the terms of the partnership agreement Harkness, Sr. retained a controlling position over the company's activities and the income therefrom.

The supplementary agreement of January 4, 1943, also contradicts any intent on the part of the alleged partners to join together their services in the conduct of United Packing Co. in 1943. By its provisions Harkness, Sr. alone was to receive compensation for services because he was to be the only active partner in the business for the duration of the war.

Finally, the actual conduct of the business of United Packing Co. in 1943 makes it clear that the parties intended for Harkness, Sr. to operate it as a sole proprietor for the duration of the war. Young Harkness and Harriet Colgate rendered no vital services nor did they participate in the management of the business during that year. Harriet was absent from Fresno the entire time. While by chance young Floyd was stationed in California during almost all of 1943 and frequently visited the

company's plant on weekends to talk over business conditions with his father, yet such visits hardly bespeak an active role in the conduct of the company, but rather a continuing interest therein by a prospective participant. The evidence reveals only one transaction, the purchase of River Ranch, where the approval of his children was sought by Harkness, Sr. Nor was Floyd, Jr.'s intent to perform future services for United Packing Co. on his return from the war sufficient to give him a partnership status in 1943. As the Supreme Court said in *Comimssioner v. Culbertson*, *supra*:

\* \* \* The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of §§ 11 and 22 (a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.

Harkness, Sr. frankly admitted in his testimony that the conduct of the company's business was not altered in 1943 but remained essentially the same as in 1942 when he operated United Packing Co. as a sole proprietor. We conclude that he continued to dominate all phases of the company's life as before and the children acquiesced in such control of the business by their father. The evidence is decisive that the income of United Packing Co. for 1943 was earned by the efforts of Harkness, Sr. and



the capital contributed by both petitioners rather than from the services or capital contributions of the son and daughter.

Nor were Harkness, Jr. and Harriet Colgate entirely free to enjoy the fruits of their respective interests in the partnership at the close of 1943. In accordance with the partnership agreement Harkness, Sr. had first call on their shares of the company's net earnings for the year to offset the credit he had advanced to Harriet's capital account and to pay off the principal and interest on both their promissory notes which he held. Only after these obligations had been met were the children allowed to exercise control over their shares of the profits of United Packing Company.

On the basis of all the evidence we believe that the three Harknesses and Harriet Colgate had no present intent but rather an indefinite future plan to operate United Packing Co. as a genuine partnership when the partnership papers were drawn up and thus we conclude and found as a fact that the Harkness children were not *bond fide* partners in 1943 within the meaning of *Commissioner v. Culbertson*, *supra*. We therefore hold that one-half of United Packing Co.'s net income for 1943 should be taxed to each of the petitioners as owners of the business in community. Due to the fact the amount of the company's net income for 1943 determined by respondent is at variance with the amount stated in the stipulation of facts, the deficiencies in the



income tax liabilities of petitioners must *de* redetermined.

Decisions will be entered under Rule 50.

[Seal]

---

[Title of District Court and Cause.]

### COMPUTATION FOR ENTRY OF DECISION

Comes now the Comimssioner of Internal Revenue, respondent above named, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and submits the attached computation of the deficiency under the opinion of The Tax Court of the United States promulgated December 22, 1949, in the above-entitled appeal.

The respondent's computation is submitted in accordance with Rule 50 of the Tax Court's Rules of Practice and is without prejudice to his right to contest the correctness of the decision pursuant to the statute in such cases made and provided.

/s/ CHARLES OLIPHANT,  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

B. H. NEBLETT,  
Division Counsel;

T. M. MATHER,  
Special Attorney,  
Bureau of Internal Revenue.

C:TS:PD  
SF:TMM:BSF: Recomputation

Audit Statement  
In re: Molly A. Harkness  
3767 Huntington Boulevard  
Fresno, California

Docket No. 16407

Deficiency letter, dated August 21, 1947

Income and Victory Tax	
Year	Deficiency
1943 .....	\$64,666.64

Recomputation of tax liability prepared in accordance with the memorandum opinion of The Tax Court of the United States promulgated December 22, 1949.

Molly A. Harkness  
Year: 1943  
Schedule 1

Recomputation Statement

Adjustments to Net Income	
	Income Tax Net Income
Net income as shown in deficiency notice.....	\$180,136.90
Net income, adjusted .....	180,011.90
Adjustment .....	\$ 125.00
Nontaxable income:	
Business income .....	\$ 125.00

Victory Tax  
Net Income

\$186,520.93  
186,395.93

\$ 125.00

\$ 125.00

Schedule 2

Explanation of Adjustment

The net profit of United Packing Company for the year 1943 is determined to be \$361,582.00 as shown in the stipulation of facts instead of \$361,832.00 as shown in the deficiency notice. Adjustment of this discrepancy results in a net decrease in profits of \$250.00, of which petitioner's community-half is \$125.00.

Schedule 3

Computation of Tax

Income tax net income, Schedule 1.....	\$180,011.90
Less: Personal exemption .....	1,100.00
Surtax net income .....	\$178,911.90
Less: Earned income credit .....	1,400.00
Balance subject to normal tax .....	\$177,511.90
Normal tax at 6% on \$177,511.90.....	\$ 10,650.71
Surtax on \$178,911.90.....	122,058.64
Income tax .....	\$132,709.35

Total income tax (brought forward) .....	\$132,709.35
Victory tax net income .....	\$186,395.93
Less: Specific exemption .....	624.00
<hr/>	
Income subject to victory tax .....	\$185,771.93
Victory tax at 5% .....	\$ 9,288.60
Less: Victory tax credit .....	500.00
<hr/>	
Net victory tax .....	8,788.60
<hr/>	
Income and victory tax .....	\$141,497.95
Income tax for 1942 as shown in deficiency notice, unchanged .....	\$ 37,095.33
Income and victory tax liability (greater amount) .....	\$141,497.95
Forgiveness feature:	
Income tax, 1942 .....	\$ 37,095.33
Amount forgiven ( $\frac{3}{4}$ ) .....	27,821.50
<hr/>	
Amount unforgiven .....	9,273.83
<hr/>	
Total income and victory tax .....	\$150,771.78
Income and victory tax shown on return (Original, Account No. 359238, First California District) .....	86,105.14
<hr/>	
Deficiency .....	\$ 64,666.64

Received and Filed T.C.U.S. January 17, 1950.

The Tax Court of the United States  
Washington

Docket No. 16407

MOLLY A. HARKNESS,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion promulgated December 22, 1949, the respondent herein filed a recomputation of tax on January 17, 1950. At the hearing on respondent's recomputation of tax held February 15, 1950, the petitioner did not appear. No objection has been filed to respondent's recomputation. It appearing that such recomputation is correct, it is, therefore, in accordance therewith,

Ordered and Decided: That there is a deficiency in income and victory tax for the year 1943 in the amount of \$64,666.64.

Entered Feb. 15, 1950.

[Seal]:       /s/ SAMUEL B. HILL,  
Judge.

Served Feb. 16, 1950.



[Title of Tax Court and Cause.]

PETITION OF MOLLY A. HARKNESS FOR  
REVIEW BY THE UNITED STATES  
COURT OF APPEALS FOR THE NINTH  
CIRCUIT OF A DECISION BY THE TAX  
COURT OF THE UNITED STATES

The taxpayer, Molly A. Harkness, petitioner in this cause, by Philip S. Ehrlich, R. J. Hecht and Albert A. Axelrod, counsel for petitioner, hereby files her petition for review by the United States Court of Appeals for the Ninth Circuit of the decision by the Tax Court of the United States promulgated December 22, 1949, 13 T. C. No. 129, determining deficiencies in income and victory taxes for the calendar year 1943, which deficiencies against the petitioner, Molly A. Harkness, was in the sum of \$64,666.64, which deficiencies were determined by the Tax Court on February 15, 1950; and said petitioner respectfully shows:

I.

The petitioner resides, and at all times mentioned in this petition has resided, in the City of Fresno, County of Fresno, State of California. She filed her separate income tax return for the calendar year 1943 with the Collector of Internal Revenue for the 1st District of California at San Francisco, California.

II.

Nature of the Controversy

The controversy involves the proper determina-

tion of the petitioner's liability for Federal Income and Victory Taxes for the calendar year 1943. The determination of the deficiency against the petitioner arose by reason of the inclusion by the respondent in the petitioner's taxable income for the taxable year 1943, on a community property basis, of all the income from the operation of a partnership composed of the petitioner, her husband, Floyd J. Harkness, the petitioner's son, Floyd J. Harkness, Jr., and the petitioner's daughter, Harriet Harkness Colgate. This partnership does business under the firm name and style of United Packing Co. During the taxable year in question, each of the persons above named owned a 25% interest in the partnership.

In connection with the controversy the Tax Court found, in part, as follows:

"Petitioners, Floyd J. Harkness and Molly A. Harkness, are individuals residing in Fresno, California. They filed their separate income tax returns for 1943 with the Collector of Internal Revenue for the First District of California. Petitioners were married July 14, 1915, and have made their home in California ever since. They have two children, Floyd J. Harkness, Jr., and Harriet Harkness Colgate, born in 1918 and 1920, respectively.

Harkness, Sr. has been a grower and shipper of fruits and vegetables since 1918. Prior to 1937 he engaged in this occupation first as an employee of various concerns and then as a member of two successive partnerships operating under the name of United Packing Co. In January 1937, petitioner

bought out his partner and commenced operating the business as a sole proprietorship under the same name. Molly Harkness, as his wife, owned the assets of the business in community with him. The company specialized in packing and shipping cantaloupes, carrots, peaches, plums, nectarines and grapes. Some commodities were raised by the company itself while others were bought from farmers on a cash basis. Still other produce was packed and shipped by the company on a commission basis. For the purposes of its business, United Packing Co. operated ranches and packing houses, and manufactured and stocked packing materials. Its main office was located in Fresno, but its operations covered a large area in the San Joaquin Valley extending northward 138 miles to Lodi and southward 127 miles to Arvin. At the close of 1942 the gross proceeds and net income earned by United Packing Co. amounted to \$1,468,119.64 and \$141,790.95, respectively.

During the years up to 1942 petitioners' two children were occupied primarily in obtaining an education, though each performed some service in their father's business. Harkness, Jr. attended schools until June, 1941 when he graduated from college with a major in commerce. From 1934 until 1941 he worked in his father's business during summer vacations and in 1937 he quit school for six months to help his father launch the sole proprietorship. From June, 1941 until January, 1942 he devoted his full time as an employee of United Packing Co. working as a 'regular field man' at a salary of



\$150 per month plus a five per cent bonus of approximately \$910. During this six-months' period he also earned four to five thousand dollars in independent deals in the fruit and vegetable business. On January 12, 1942, he entered the United States Air Corps as a private. At the close of 1942 petitioners' son still had a credit on the books of the sole proprietorship of \$1,412.05 for prior services performed. He owned no substantial property outside of these earnings at that time.

Harriet Harkness finished her schooling in June, 1942 when she graduated from college. During summer vacations she had occasionally performed secretarial services in her father's business. Harriet worked full time as a secretary at United Packing Co. from June until August, 1942 at which time she married William H. Colgate, Jr., who was then serving in the United States Army. Following her marriage she spent her time housekeeping for her husband at various military posts in the United States until October, 1944. She owned no significant amount of property at the time of her marriage.

Harriet's husband, William Colgate, had resided in Fresno County, California, all his youth and had been an acquaintance of the Harkness family for a number of years prior to his marriage in 1942. He attended college, majoring in commerce, and during summer vacations was employed by Peerless Pump Company, the largest supplier of irrigation pumps in the San Joaquin Valley. Colgate later quit school and worked full time for this company



for nine months before enlisting in the United States Army in March, 1941. This was in keeping with his desire to devote his career to agricultural pursuits in the Valley. As an assistant foreman aiding in the installation of extensive irrigation systems, Colgate acquired considerable knowledge of the mechanics of irrigation. After his marriage to Harriet, they were stationed at Columbus, Ohio, during the latter part of 1942 and throughout 1943.

In the fall of 1942 Harkness, Sr. became convinced that it would be advantageous to convert the operation of his fruit packing and shipping business from a sole proprietorship to a partnership composed of his wife, himself and his two children in the coming year. Many reasons dictated that decision. Primarily he desired to obtain the services of his son and son-in-law in the business. He felt that as a result of their college education and the practical experience they had gained pursuing agricultural employment in the Valley that they would make skilled, competent supervisors capable of overseeing the widespread operations of the company. Secondly, from his experience in the fruit and vegetable packing industry, Harkness believed that it was essential to increase the capital investment in the company by allowing annual profits to remain in the business. This was necessary not only to permit payment of extensive operating expenses, to allow for expansion of company facilities and equipment and to develop new business, but also to meet the exigencies of bad crop years when the com-

pany's income declined drastically. Furthermore, in 1942 fruit packers were anticipating a decline in profits due to labor shortages, low transportation priorities for their produce, and the probability that prices would tumble as in World War I. These circumstances only increased the need for increasing the capital reserve of United Packing Co. Yet it had been Harkness' experience in past years that to hold qualified supervisory personnel it was necessary to pay them large bonuses or percentages of profits which they invariably withdrew from the business and often used to set themselves up in competition with him, thus draining the company's capital. He felt the only way to retain profits in the company was to bring into the business persons who felt as he did. Through long discussions with Harkness, Jr. and William Colgate, petitioner knew that they agreed with him that only a reasonable amount of the profits should be withdrawn from United Packing Co. and the rest of the net income should be allowed to accumulate in the business.

While Harkness, Sr. was well aware that neither Floyd, Jr., nor William Colgate would be available to serve United Packing Co. for the duration of the war and he would be the only active partner in the meantime, yet he desired them to acquire an interest in the company at this time to guarantee their future help in running the business after their release from the Army.

Furthermore, formation of the partnership accorded with the wish of Harkness, Sr. to give his children an opportunity to make good. Even when

Floyd, Jr. was a boy he and his father planned for the day when the former would be a full-fledged partner. After graduation from college in 1941 Harkness, Jr. had pressed his father to give him the status of a partner in the business, and while Harkness, Sr. had too many financial commitments to do so in that year, yet he promised his son he would make provision for him to purchase an interest in the business. Now petitioner desired to fulfill that promise. It was long understood that if one child was given an opportunity to participate in the business, the other would be given an equal opportunity. Offering Harriet an opportunity to become a partner in his business not only fulfilled this pledge, but was a long step toward securing the eventual services of her husband which petitioner so greatly desired.

While Harkness, Sr. consulted a lawyer concerning the feasibility of converting his business into a partnership and was thus aware of the tax saving possibilities inherent therein, yet this fact was only a secondary consideration with him, and he would have entered into this arrangement regardless thereof.

During the fall of 1942 Harkness, Sr. held lengthy conversations with his son, who was stationed at a nearby airfield, regarding the proposed partnership. Harkness, Jr. eagerly accepted the chance to buy an interest in United Packing Co. for this had been his great desire for many years and assured him of full participation in the business on his re-



turn from the service. Petitioners and young Harkness then definitely planned to convert the business into a partnership starting in 1943.

Over the same period of time Harkness, Sr. also corresponded with his daughter and offered her either the opportunity to invest in United Packing Co. or some other enterprise. Furthermore, it was understood that if she decided to come into her father's business, her husband, William Colgate, would be allowed to participate in the partnership following his release from the Army. Harriet and William Colgate debated at length whether it was advisable for her to buy an interest in her father's business or invest elsewhere. Finally Harriet exercised her option to procure an interest in United Packing Co. after her husband determined he wanted to be associated with United Packing Co. upon his return from the service.

Thus by November, 1942 petitioners and both their children generally agreed to the formation of a partnership for the operation of United Packing Co. in the coming year, though the details of the partnership relationship had not been worked out. A "Certificate of Co-Partnership Transacting Business under Fictitious Name" was executed on November 12, 1942, which petitioners and young Harkness signed on that date and Harriet signed on November 28. It stated that the four were co-partners carrying on business under the name of United Packing Co. and that Harkness, Sr. was the general manager in full charge of all business operations. This certificate was published in a



local paper and later filed with the County Recorder of Fresno County.

On December 31, 1942, "Articles of Partnership," providing the detailed terms of the proposed partnership, were drafted and met the approval of all but Harriet Colgate, who refused to sign until provisions as to control of the business and as to purchase of a deceased partner's share were modified.

On January 1, 1943, petitioners transferred to United Packing Co., a partnership, most of the assets and some of the liabilities of United Packing Co., sole proprietorship, existing on December 31, 1942, resulting in a net worth of \$138,241.61 for the partnership on that date. Harkness, Jr. and Harriet Colgate each bought a one-fourth interest in the partnership for \$34,560.41, equivalent to one-fourth of its net worth. To pay Harkness, Sr. for his share in the partnership the son used \$1,392.05 of the credit he had earned as compensation for prior services rendered the sole proprietorship and on January 2, 1943, signed a promissory note for the remaining \$33,168.35 with interest at four per cent per annum. Harriet Colgate purchased her partnership interest from her father with a promissory note dated January 2, 1943, for \$34,560.40 plus four per cent interest per annum. William Colgate joined her on the note as co-maker. No collateral was required on either note.

These transactions were reflected on the books of United Packing Co., co-partnership, as of January 1, 1943. It showed assets of \$142,861.03 and

liabilities of \$4,619.92 and a net worth of \$138,241.61. Capital of the partnership was stated to be \$138,241.61 resulting from contributions of \$34,560.41 each from the three Harknesses and Harriet Colgate.

On January 4, 1943, pending acceptance by Harriet Colgate of the articles of partnership drafted on December 31, 1942, Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate signed a supplemental agreement fixing compensation and distribution of partnership profits among the partners. The salary of Harkness, Sr., as general manager of the partnership, was fixed at 75 per cent of the first \$100,000 of the partnership net income. There was no provision for salaries for the other partners. The remainder of the first \$100,000 of partnership net income was to be divided equally among the partners, as were any profits over that amount.

\* \* \*

During January, 1943, Harkness, Sr. discussed with the Colgates the modifications sought by Harriet Colgate in the partnership agreement drafted on December 31, 1942. Harriet withdrew her objections when the original draft was altered to meet her demands. The reformed partnership agreement was signed by the three Harknesses on February 27, 1943, and by Harriet Colgate on March 10, 1943.

\* \* \*

In February, 1943, an undivided one-half interest

in a 300-acre vineyard and orchard was acquired by Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate as tenants in common. The other half interest in the ranch was acquired by Chris Sorenson and his wife. Sorenson was a supervisory employee of United Packing Co. All funds for purchase of the vineyard were supplied by United Packing Co. and the amount loaned to Sorenson was repaid to the company by him. The 50 per cent interest acquired by the Harknesses and Harriet Colgate was included as an asset of United Packing Co. and subsequent income therefrom was included in its net income. Previously on January 16, 1943, by a bill of sale the personal property on the River Ranch had been conveyed to Chris A. Sorenson and Katharine Sorenson, his wife, and "Floyd J. Harkness, Molly A. Harkness, Harriet Harkness Colgate and Floyd J. Harkness, Jr., co-partners, doing business under the firm name and style of United Packing Co., a co-partnership." Prior to these purchases, all the partners were consulted with respect to them, and Harkness, Jr., who was familiar with the land, approved the transactions.

During the year 1943 there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr. Harriet and William Colgate were absent from Fresno until his discharge from the armed services in October 1944, so consequently she performed no services for United Packing Co. during the year 1943 nor did she participate in the



management of its affairs. Throughout the year 1943 until December, Harkness, Jr. was stationed at Hamilton Field, California, approximately six hours traveling time from Fresno, and frequently visited the company's office and packing plants on weekends. While he was unable to participate in the business activities, yet he discussed its problems with his father on these occasions. In December, 1943 Harkness, Jr. went overseas with the Air Corps and did not return to Fresno until January, 1946.

In 1943 United Packing Co. earned gross proceeds of \$2,572,905.53 and a net income of \$361,582. In accordance with the terms of the supplemental agreement Harkness, Sr. was paid a salary of \$75,000 and Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate each were credited with \$71,645.50 as their respective shares of the profits.

Harriet's credit on the partnership books was first applied to pay off the principal and interest on her promissory note to Harkness, Sr., in the amount of \$35,942.82, and to offset prior withdrawals from her capital account consisting of cash in the amount of \$112.97 and sums of \$1,070.89 and \$31,423.67 paid to the Collector of Internal Revenue. The balance of \$3,095.15 which she left in the business at the close of 1943 was withdrawn in 1944 to pay for taxes and personal expenditures. Of the \$71,645.50 credited to Harkness, Jr., \$34,495.08 was turned over to his father to pay the principal and interest on his promissory note. Of the remaining \$37,150.42 which he left in the business in 1943, young



Harkness expended \$331.58 for his own use in 1944.

United Packing Co. filed a partnership return for the year 1943, reporting a net income of \$361,-582, compensation of \$75,000 paid to Harkness, Sr., and the distribution of \$71,645.50 from profits to each of the three Harknesses and to Harriet Colgate.

Harkness, Sr. and Molly Harkness filed separate income tax returns in 1943. As residents of a community property state, each reported one-half of the total income of \$218,291 they together received from United Packing Co. in 1943, or \$109,145.50.

In his notices of deficiency sent to petitioners, respondent determined that the net income of United Packing Co. for 1943 was \$361,823 and that each petitioner realized one-half of this amount, or \$180,-916, as community property income. The notice of deficiency sent to Harkness, Sr. stated in part:

“(a) On December 31, 1942, you and your wife, Molly A. Harkness, together with your two children, Floyd James Harkness, Jr. and Harriet Harkness Colgate, executed an instrument purporting to create a family partnership. Since Floyd James Harkness, Jr. and Harriet Harkness Colgate contributed no capital originating with themselves, rendered no services to the business, and were not required to participate in the control and management of the business under the terms of the alleged partnership agreement, it is held that they did not acquire valid partnership interests in the United Packing Company. Accordingly, profits

from the above-named organization are reallocated to you and your wife on a community property basis, thus increasing your taxable income by \$71,770.50 as shown below.

Total net profit of United Packing

Company .....	\$361,832.00
Your community one-half share .....	180,916.00
Amount reported on return .....	109,145.50

---

Adjustment—Increase .....\$ 71,770.50''

Similar language was contained in the notice of deficiency received by Molly Harkness.

The three Harknesses and Harriet Colgate had no intent to join together in conducting the business of United Packing Company as bona fide partners in 1943 and thus their partnership was not valid for tax purposes in that year."

The Tax Court, in its opinion, held that the petitioner, her husband, and their children had no intent to join together in conducting the business of United Packing Co. as bona fide partners in 1943, and that their partnership was not valid for tax purposes in that year.

### III.

The said taxpayer, to wit, Molly A. Harkness, being aggrieved by the Findings of Fact and Conclusions of Law contained in said Findings and Opinions of the Court and by the Tax Court's decisions entered pursuant thereto, desires to obtain a review thereof by the United States Court of Appeals for the Ninth Circuit.

## IV.

The petitioner assigns as error the following acts and omissions of the Tax Court of the United States:

1. The Tax Court erred in finding contrary to the record that:

“During the year 1943 there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr.”

2. The Tax Court erred in finding contrary to the record that no collateral was required to secure the notes given by Harriet Colgate and Floyd J. Harkness, Jr. to petitioner and her husband.

3. The Tax Court erred in finding contrary to the record as a whole that:

“The three Harknesses and Harriet Colgate had no intention to join together in conducting the business of United Packing Co. as bona fide partners in 1943 and thus their partnership was not valid for tax purposes in that year.”

4. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., upon his return from the Army in January, 1946, was appointed Assistant General Manager of the partnership business, and has ever since that time, and up to January 11, 1949, the date of the hearing of this case, rendered substantial managerial services to the business.



5. The Tax Court erred in not finding, as the record shows, that during the year 1946 Floyd J. Harkness, Jr. received the sum of \$57,984.85, and during the year 1947 the sum of \$53,635.13, as salary for each of said years for services rendered as such Assistant General Manager.

6. The Tax Court erred in not finding, as the record shows, that during the period 1946 to 1947, Floyd J. Harkness, Jr. withdrew from the partnership business a total sum of \$121,484.51.

7. The Tax Court erred in not finding, as the record shows, that William Colgate was discharged from the Army in the Fall of 1944, and immediately went to work for the partnership, and in not finding that in January, 1945, William Colgate became a fifth partner in the enterprise.

8. The Tax Court erred in not finding, as the record shows, that William Colgate has ever since January, 1945, been the Manager of the Clovis-Sanger District of the partnership and has rendered substantial services of a supervisory and managerial nature to the partnership, and in not finding that he has received the following compensation for his services: 1944, \$450.00; 1945, \$5,275.00; 1946, \$46,554.79; 1947, \$35,928.45.

9. The Tax Court erred in not finding, as the record shows, that during the period 1944 to 1947, William Colgate and Harriet Colgate have withdrawn \$100,138.48 from the partnership.



10. The Tax Court erred in not finding, as the record shows, as a whole, that Floyd J. Harkness, Jr., and Harriet Colgate were and have been ever since January 1, 1943, the true owners of an undivided interest in the assets of the partnership.

11. The Tax Court erred in not finding, as the record shows as a whole, that Floyd J. Harkness, Jr. and William Colgate made, as of the date of the formation of the partnership, a commitment to render services to the partnership as soon as circumstances permitted.

12. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., Harriet Colgate and petitioner and her husband were co-owners, as tenants in common, of one-half of the Ranch known as the "River Ranch," each owning an undivided  $\frac{1}{8}$ th interest therein, and in not finding that during the year 1943 the profits derived from the operation of this Ranch amounted to \$60,309.92, and in not finding that the  $\frac{1}{8}$ th interest of each of the children yielded an income belonging to them in the sum of \$15,077.48 each.

13. The Tax Court erred in not finding, as the record shows, that Harriet Colgate and Floyd J. Harkness, Jr. pledged the first income to be derived from the business of the partnership to the payment of the notes given by them to petitioner and her husband.

14. The Tax Court erred in not finding, as the record shows, that petitioner and her husband and

Harriet Colgate and Floyd J. Harkness, Jr. intended to join together in conducting the business of United Packing Co. as bona fide partners in 1943 and that their partnership was valid for tax purposes for that year.

15. The Tax Court erred in that its decision herein is contrary to the applicable decisions of the Supreme Court of the United States.

16. The Tax Court erred herein in that its decision is contrary to the applicable decisions of the Tax Court heretofore made.

17. The Tax Court erred in finding, contrary to the record, a deficiency for the year 1943, in lieu of a finding that there is no income tax due from the petitioner for said year.

Wherefore, petitioner prays for a review by the United States Court of Appeals for the Ninth Circuit of the decision by the United States Tax Court, promulgated December 22, 1949, 13 T.C. No. 129; and that upon such review said Honorable Court make and enter a decree setting aside and reversing said decision of the United States Tax Court, and determine that the respondent, the Commissioner of Internal Revenue, erred in reallocating the income of the partnership known as United Packing Co. and in such reallocation reallocating to the petitioner, namely, Molly A. Harkness, and to her husband, Floyd J. Harkness, Sr., on a community basis, the entire income from said partnership; and should further determine that there was no de-

iciency in income taxes or victory taxes for the year 1943 from said petitioner.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Counsel for Petitioner.

State of California,

City and County of San Francisco—ss.

Albert A. Axelrod and R. J. Hecht, being first duly sworn, depose and say:

That they are counsel of record in the above-entitled cause; that as such counsel they are authorized to verify the foregoing petition for review, that they have read said petition and are familiar with the statements contained therein; that the statements made are true to the best of each of their knowledge, information and belief.

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT.

Subscribed and sworn to before me this 10th day of May 1950.

[Seal] /s/ GLADYS C. OKERSTROM,  
Notary Public in and for the City and County of  
San Francisco, State of California.

My Commission Expires October 27, 1952.

Received and Filed May 12, 1950.

In the United States Court of Appeals  
For the Ninth Circuit

Docket No. 16407

MOLLY A. HARKNESS,

Petitioner on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent on Review.

NOTICE OF FILING PETITION  
FOR REVIEW

To: Charles Oliphant,  
Chief Counsel,  
Bureau of Internal Revenue.

You are hereby notified that the above-petitioner did, on the 12th day of May, 1950, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit, of the decision of this Court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this 16th day of May, 1950.

/s/ VICTOR S. MERSCH,

Clerk, The Tax Court of the  
United States.



Service of Copy of Petition for Review Acknowledged this 16th day of May, 1950.

/s/ CHARLES OLIPHANT,  
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

Filed T.C.U.D. May 16, 1950.

---

In the Tax Court of the United States

No. 16,407

MOLLY A. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

PRAECIPE FOR RECORD

To the Clerk of the Tax Court of the United States:

You are hereby respectfully requested to prepare and certify and transmit to the Clerk of the United States Court of Appeals for the Ninth Circuit, with reference to Petition for Review heretofore filed by the petitioner in the above-entitled cause, a transcript of record in the above cause prepared and transmitted as required by law and by the rules of said court, and to include in said transcript of record the following documents or certified copies thereof, to wit:

1. The docket entries of all proceedings before the Tax Court.
2. Pleadings before the Tax Court of the United States as follows:
  - (a) Petition for redetermination.
  - (b) Answer of respondent.
3. Stipulation of facts filed at the hearing January 11, 1949.
4. Reporter's transcript of the proceedings and testimony before the Tax Court on January 11, 1949.
5. The following exhibits introduced in evidence before the Tax Court on January 11, 1949:
  - (a) Joint exhibits: 10-J, 11-K, 12-L.
  - (b) Petitioner's exhibits: 13, 14, 15, 16, 17, 18.
  - (c) Respondent's exhibits M, N.
6. Notice under Rule 50.
7. Respondent's computation for entry of decision.
8. Stipulation signed by counsel for petitioner with respect to the computation of respondent. [No record hereof located Victor S. Mersch.]
9. Decision of the Tax Court.
10. Petition for Review filed by petitioner.
11. This praecipe.
12. Notice of Filing Petition for Review.

Dated: July 10, 1950.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Attorneys for Petitioner,  
Molly A. Harkness.

Affidavit of Service by Mail attached.

Received and Filed, T.C.U.S., July 12, 1950.

---

[Title of Tax Court and Cause.]

### CERTIFICATE

I, Victor S. Mersch, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 15, inclusive, constitute and are all of the original papers and proceedings on file in my office as called for by the "Praeceptum for Record" in the proceeding before the Tax Court of the United States entitled: "Molly A. Harkness, Petitioner, v. Commissioner of Internal Revenue, Respondent," Docket No. 16407, and in which the petitioner in the Tax Court proceeding has initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court proceeding, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United

States, at Washington, in the District of Columbia,  
this 14th day of July, 1950.

[Seal]      /s/ VICTOR S. MERSCH,  
Clerk.

---

[Endorsed]: No. 12618. United States Circuit  
Court of Appeals for the Ninth Circuit. Molly A.  
Harkness, Petitioner, vs. Commissioner of Internal  
Revenue, Respondent. Transcript of the Record  
upon Petition to Review a Desision of the Tax  
Court of the United States.

Filed: July 19, 1950.

/s/ PAUL P. O'BRIEN,  
Clerk of the United States Circuit Court of Ap-  
peals for the Ninth Circuit.



In the United States Court of Appeals for the  
Ninth Circuit

No. 12618

MOLLY A. HARKNESS,

Petitioner and Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent and Appellee.

APPLICATION FOR EXTENSION OF TIME  
WITHIN WHICH TO FILE RECORD AND  
DOCKET CASE ON A PETITION FOR  
REVIEW FROM A DECISION OF THE  
TAX COURT OF THE UNITED STATES

To the Honorable Justices of the United States  
Court of Appeals for the Ninth Circuit:

The above-named petitioner, Molly A. Harkness, through her counsel, hereby applies to this Honorable Court for an extension of time within which to file the record and docket her case after filing of the petition for review in the Tax Court of the United States.

This application is made on the ground of excusable neglect of one of counsel for said petitioner, in failing to file with the Clerk of the Tax Court of the United States a praecipe designating the record to be transmitted to the Clerk of this Honorable Court, within the forty-day period called for by Rule 31 of this Honorable Court.

This application is supported by the affidavit of R. J. Hecht, one of counsel for petitioner, and points and authorities likewise attached to this application.

Petitioner respectfully requests that she be granted a reasonable time within the discretion of the above-entitled court within which the Clerk of the Tax Court may file with the Clerk of this Honorable Court said record, and within which said case may be docketed.

Dated: July 7, 1950.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Attorneys for Petitioner and Appellant Molly A.  
Harkness.

Ordered time of petitioner to file transcript of record and docket cause extended to August 1, 1950.

/s/ WILLIAM HEALEY,

/s/ WM. E. ORR,

/s/ WALTER L. POPE,

U. S. Circuit Judges.

[Endorsed]: Filed July 8, 1950.

[Title of Tax Court and Cause.]

STATEMENT OF POINTS ON WHICH APPELLANT INTENDS TO RELY AND DESIGNATION OF PARTS OF THE RECORD NECESSARY FOR CONSIDERATION THEREOF

Appellant proposes, on her appeal, to rely on the following points:

1. The following ultimate finding of the Tax Court is contrary to its evidentiary findings:

“The three Harknesses and Harriet Colgate had no intent to join together in conducting the business of United Packing Co. as bona fide partners in 1943 and thus their partnership was not valid for tax purposes in that year.”

2. The ultimate finding set forth in 1 above is based upon a misapplication of the law.

3. The ultimate finding set forth in 1 above is clearly erroneous because it is against the clear weight of the evidence and is arrived at by accepting part of the evidence and totally disregarding other convincing evidence.

4. The following finding of fact is clearly erroneous because it is against the clear weight of the evidence and is arrived at by accepting part of the evidence and totally disregarding other convincing evidence:

“During the year 1943 there was no change in the operation of the United Packing Co.

over prior years. The business was still completely under the control of Harkness, Sr.”

5. The following ultimate finding of the Tax Court is contrary to its evidentiary findings:

“No collateral was required on either note.”

6. The ultimate finding set forth in 5 above is clearly erroneous because it is against the clear weight of the evidence.

7. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., upon his return from the Army in January, 1946, was appointed Assistant General Manager of the partnership business, and has ever since that time, and up to January 11, 1949, the date of the hearing of this case, rendered substantial managerial services to the business.

8. The Tax Court erred in not finding, as the record shows, that during the year 1946 Floyd J. Harkness, Jr., received the sum of \$57,984.85, and during the year 1947 the sum of \$53,635.13, as salary for each of said years for services rendered as such Assistant General Manager.

9. The Tax Court erred in not finding, as the record shows, that during the period 1946 to 1947 Floyd J. Harkness, Jr., withdrew from the partnership business a total sum of \$121,484.51.

10. The Tax Court erred in not finding, as the record shows, that William Colgate was discharged from the Army in the Fall of 1944, and immedi-



ately went to work for the partnership, and in not finding that in January, 1945, William Colgate became a fifth partner in the enterprise.

11. The Tax Court erred in not finding, as the record shows, that William Colgate has ever since January, 1945, been the Manager of the Clovis-Sanger District of the partnership and has rendered substantial services of a supervisory and managerial nature to the partnership, and in not finding that he has received the following compensation for his services: 1944, \$450.00; 1945, \$5,275.00; 1946, \$46,554.79; 1947, \$35,928.45.

12. The Tax Court erred in not finding, as the record shows, that during the period 1944 to 1947 William Colgate and Harriet Colgate have withdrawn \$100,138.48 from the partnership.

13. The Tax Court erred in not finding, as the record shows, as a whole, that Floyd J. Harkness, Jr., and Harriet Colgate were and have been ever since January 1, 1943, the true owners of an undivided interest in the assets of the partnership.

14. The Tax Court erred in not finding, as the record shows as a whole, that Floyd J. Harkness, Jr., and William Colgate made, as of the date of the formation of the partnership, a commitment to render services to the partnership as soon as circumstances permitted.

15. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., Harriet Colgate and appellant and her husband, Floyd J.

Harkness, Sr., were co-owners, as tenants in common, of one-half of the Ranch known as the "River Ranch," each owning an undivided 1/8th interest therein, and in not finding that during the year 1943 the profits derived from the operation of this Ranch amounted to \$60,309.92, and in not finding that the 1/8th interest of each of the children yielded an income belonging to them in the sum of \$15,077.48 each.

16. The Tax Court erred in not finding, as the record shows, that Harriet Colgate and Floyd J. Harkness, Jr., pledged the first income to be derived from the business of the partnership to the payment of the notes given by them to appellant and her husband.

17. The Tax Court erred in not finding, as the record shows, that appellant and her husband and Harriet Colgate and Floyd J. Harkness, Jr., intended to join together in conducting the business of United Packing Co. as bona fide partners in 1945 and that their partnership was valid for tax purposes for that year.

18. The Tax Court erred in that its decision herein is contrary to the applicable decisions of the Supreme Court of the United States. (Commissioner of Internal Revenue v. Culbertson, 337 U. S. 733; Commissioner of Internal Revenue v. Tower, 327 U. S. 280.)

19. The Tax Court erred herein in that its decision is contrary to the applicable decisions of the

Tax Court heretofore made. (Issac Blumberg, 11 T. C. 663.)

20. The Tax Court erred in finding, contrary to the record, a deficiency for the year 1943, in lieu of a finding that there is no income tax due from appellant for said year.

Appellant designates the following portions of the record as necessary for the consideration of the foregoing points:

- (a) The petition of Molly A. Harkness.
- (b) Answer of Commissioner of Internal Revenue.
- (c) Stipulation of facts and Exhibits 1-A through 9-I, attached.
- (d) Official report of proceedings before the Tax Court.
- (e) The following joint exhibits attached to the petition: 10-J, 11-K and 12-L.
- (f) Exhibits 13, 14, 15, 16, 17, 18, and M and N.
- (g) Findings of fact and opinion of the Tax Court.
- (h) Respondent Commissioner's computation for entry of decision.
- (i) Decision.
- (j) Petition for review.
- (k) Proof of service of petition for review.
- (l) Application and order re extension of time to transmit record. (Please omit affidavit in support of application and points and authorities.)
- (m) Praeceptum for record.

(n) Certificate of Clerk of Tax Court of the United States.

(o) This statement of points on which appellant intends to rely and designation of parts of the record necessary for consideration thereof.

Dated at San Francisco, California, July 24, 1950.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Attorneys for Appellant  
Molly A. Harkness.

[Endorsed]: Filed July 25, 1950.

---

[Title of Tax Court and Cause.]

### STIPULATION FOR CONSOLIDATION ON PETITION FOR REVIEW

It Is Hereby Stipulated by and between the parties, through their respective counsel, that the above-entitled cause be consolidated with the case of Floyd J. Harkness, Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 12619, and that for the purposes of said consolidated petitions the parties will rely upon the record in the above-entitled cause.

It Is Likewise Stipulated by and between the parties, through their respective counsel, that the petitions for review in this cause, and in the cause of Floyd J. Harkness, Petitioner, vs. Commissioner



of Internal Revenue, Respondent, No. 12619, be consolidated for the purposes of brief, argument and opinion.

Dated: August 11, 1950.

/s/ THERON L. CAUDLE,  
Assistant Attorney General.

.....

Charles Oliphant,  
Attorneys for Respondent.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,  
Attorneys for Petitioner.

It Is Ordered: That the above causes be consolidated for purposes of brief and argument.

/s/ WILLIAM DENMAN,  
Judge of the United States  
Court of Appeals.

/s/ CLIFTON MATHEWS,

/s/ WILLIAM HEALY,  
Judges, U. S. Court of  
Appeals for the 9th Circuit.

[Endorsed]: Filed August 17, 1950.



No. 12619

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

FLOYD J. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

---

Transcript of Record

---

Petition to Review a Decision of the Tax Court  
of the United States

FILED

OCT 24 1950

PAUL P. O'BRIEN,

CLERK





No. 12619

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

FLOYD J. HARKNESS,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

---

Transcript of Record

---

Petition to Review a Decision of the Tax Court  
of the United States



## INDEX

---

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

### PAGE

Answer .....	10
Appearances .....	1
Application for Extension of Time Within Which to File Record and Docket Case on a petition for Review From a Decision of the Tax Court of the United States.....	40
Certificate of Clerk.....	38
Computation for Entry of Decision.....	11
Decision .....	15
Notice of Filing Petition for Review.....	35
Petition .....	2
Petition of Floyd J. Harkness for Review by the United States Court of Appeals for the Ninth Circuit of a Decision by the Tax Court of the United States.....	16
Praeipie for Record .....	36
Statement of Points on Which Appellant In- tends to Rely and Designation of Parts of the Record Necessary for Consideration Thereof .....	42
Stipulation for Consolidation on Petition for Review .....	47





## APPEARANCES

For Petitioner:

PHILIP S. EHRLICH, ESQ.,

R. J. HECHT, ESQ.

LeROY H. GUNTHER, ESQ.,

ALBERT A. AXELROD, ESQ.,

For Respondent:

T. M. MATHER, ESQ.,

R. C. WHITLEY, ESQ.

The Tax Court of the United States

FLOYD J. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

### PETITION

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Office of Internal Revenue Agent in Charge, San Francisco Division, IRA :90-D-DMR) dated August 21, 1947, and as a basis of his proceeding, alleges as follows:

1. The petitioner is an individual with his residence at 3767 Huntington Boulevard, in the City of Fresno, State of California. The return for the period here involved was filed with the Collector for the First District of California.

2. The notice of deficiency (a copy of which is attached hereto and marked Exhibit "A") was mailed to the Petitioner on August 21, 1947.

3. The taxes in controversy are income and victory taxes for the calendar year 1943, in the amount of \$65,367.27.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The refusal of the respondent to recognize

that the petitioner and his wife, Molly A. Harkness, and their children, Floyd James Harkness, Jr. and Harriet Harkness Colgate, were copartners transacting business under the firm name and style of United Packing Co.;

(b) The determination by the respondent that the said Floyd James Harkness, Jr. and Harriet Harkness Colgate contributed no capital to said partnership known as United Packing Co., originating with themselves;

(c) The determination by the respondent that the said Floyd James Harkness, Jr. and Harriet Harkness Colgate rendered no services to the business of the partnership known as United Packing Co.;

(d) The determination by the respondent that the said Floyd James Harkness, Jr. and Harriet Harkness Colgate did not acquire valid partnership interests in the said United Packing Co.;

(e) The re-allocation of the profits of the said partnership known as United Packing Co. by the respondent to the petitioner and his wife, Molly A. Harkness, on a community property basis, thus increasing petitioner's taxable income by \$71,-770.50.

5. The facts upon which petitioner relies as a basis of this proceeding are as follows:

(a) On December 31, 1942, petitioner, Molly A. Harkness, Floyd James Harkness, Jr. and Harriet Harkness Colgate entered into written Articles of Copartnership, under and by virtue of the terms of which they agreed, among other things, to become copartners in the business of growing, packing, ship-

ping and distributing fresh fruits and vegetables in the State of California under the firm name and style of United Packing Co., commencing January 1, 1943, and continuing until the partners should dissolve the partnership or until the partnership should be dissolved as provided in said partnership agreement. A copy of said Articles of Copartnership is attached hereto and marked Exhibit "B" and made a part hereof.

(b) Petitioner and Molly A. Harkness are husband and wife, and Floyd James Harkness, Jr. and Harriet Harkness Colgate are their children.

(c) The partnership capital consisted of cash and real and personal property having a value of \$138,241.61, which capital was contributed by the partners in equal amounts. The interests of the husband and wife were community property and it retained that character. There has been no attempt on the part of the husband and wife to convert the wife's or the husband's interests into separate property. The children borrowed the funds for their capital contributions from their father and gave him their respective promissory notes for such borrowed funds, which notes have been paid by the children in full with interest.

(d) The present partnership was the successor to several previous partnerships, the first of which was started in 1923, under the same name, to-wit, United Packing Co. The succeeding partnerships have engaged in similar businesses uninterrupted since the organization of the first partnership. The petitioner was a partner in each of the respective



partnerships, and in which partnerships persons other than members of the petitioner's family were members.

(e) At the time the said partnership agreement, (Exhibit "B" attached hereto) was entered into, Harriet Harkness Colgate was married to William H. Colgate, Jr. He and Floyd James Harkness, Jr. were both in the armed forces of the United States. Floyd James Harkness, Jr. entered the United States armed forces on January 12, 1942, and was discharged therefrom on January 6, 1946. William H. Colgate, Jr. entered the United States armed forces in 1941, and was discharged therefrom in September, 1944.

Under the terms of the partnership agreement and subsequent agreement between the parties, it was contemplated and agreed that Floyd James Harkness, Jr. and William H. Colgate, Jr., the husband of Harriet Harkness Colgate, would actively engage in the business of the partnership as soon as they were able to do so. Both of them had been trained for this purpose. William H. Colgate, Jr. was to represent his wife in the partnership, the wife's interest in the partnership as well as the profits arising from the interest being community property under the community property laws of the State of California, and accordingly the said William H. Colgate, Jr. had a vested interest in both the profits and capital of the partnership.

At the time the Articles of Copartnership were entered into, it was agreed and realized that a major portion of the work of the partnership would have to

be performed by the petitioner herein, until Floyd James Harkness, Jr., and William H. Colgate, Jr., were discharged from the armed forces and were able to actively take an interest in the partnership, and by reason of such fact there was a provision inserted in the Articles of Copartnership (Exhibit "B" attached hereto) to the effect that petitioner was to be the general manager of the partnership and was to devote such portion of his time towards the business of the partnership as he should deem necessary and proper for the business of the partnership; that he was to receive for his services a certain percentage of the net profits of the business to be agreed upon between the partners from time to time, and that the remaining income of the partnership should be divided equally between all the partners; that on January 4, 1943, a supplemental agreement was entered into between the partners, fixing this compensation as 75% of the net income from the said partnership, United Packing Co., up to the amount of \$100,000 which agreement stated that this compensation was being paid to him by reason of the fact that due to war conditions he was the only active copartner in the business of the partnership at that particular time. A copy of said agreement is attached hereto marked Exhibit "C" and made a part hereof.

(f) One of the principal assets of the partnership was an undivided interest in a 300-acre vineyard and orchard which was acquired on February 8, 1943. The title to said vineyard and orchard was vested as follows:

1/8 undivided interest in Floyd J. Harkness, Sr., taxpayer;

1/8 undivided interest in Molly A. Harkness, petitioner's wife;

1/8 undivided interest in Floyd James Harkness, Jr. and his wife;

1/8 undivided interest in Harriet Harkness Colgate and William H. Colgate, Jr., her husband.

The other 1/2 interest in said property was owned by Chris A. Sorensen (a former partner of United Packing Co.) and his wife.

One-half of the profits from the operation of the vineyard and orchard inured to the benefit of the partnership and was reported as such in the partnership income tax return. This one-half of the profits for the year 1943 amounted to the sum of \$60,309.92, all of which profits were re-allocated by the respondent to petitioner and his wife, Molly A. Harkness, instead of having been apportioned among the owners of said property on a partnership basis as reported in the income tax returns of the partnership and the respective income tax returns of the partners.

(g) In September, 1944, said William H. Colgate, Jr. received a medical discharge from the United States Army, and he thereafter immediately entered the services of the United Packing Co., and has devoted his entire time and attention since said date to the business and interests of the said United Packing Co.

(h) On January 6, 1946, Floyd James Harkness, Jr. was discharged from the United States Army,



and he thereafter immediately entered the services of the United Packing Co., and has devoted his entire time and attention since said date to the business and interests of the said United Packing Co.

Wherefore, petitioner prays that this Court may hear this proceeding and determine that the respondent erred in re-allocating the income of the partnership known as United Packing Co., and in such re-allocation, re-allocating to the petitioner and the petitioner's wife, Molly A. Harkness, on a community property basis the entire income from said partnership, thus increasing the taxable income of the petitioner by the sum of \$71,770.50, and that this Court should determine that the correct amount of the petitioner's income tax and victory tax liability for the said year be re-computed in accordance with Rule 50.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ LeROY H. GUNTHER,

Counsel for Petitioner.

State of California,  
County of Fresno—ss.

Floyd J. Harkness, being first duly sworn, deposes and says:

That he is the petitioner above named; that he has read the foregoing Petition and is familiar with the statements contained therein, and that the statements contained therein are true except those stated



to be upon information and belief, and that those he believes to be true.

/s/ FLOYD J. HARKNESS.

Subscribed and sworn to before me this 29th day of October, 1947.

[Seal] /s/ HARRY R. BRADLEY,  
Notary Public in and for the County of Fresno,  
State of California.

[Exhibit A attached to Petition is identical to Exhibit A attached to the Petition in Transcript No. 12681 and is set out in full at pages 9 to 14.]

[Exhibit B attached to the Petition is identical to Exhibit B attached to the Petition in Transcript No. 12681 and is set out in full at pages 14 to 26.]

[Exhibit C attached to the Petition is identical to Exhibit C attached to the Petition in Transcript No. 12681 and is set out in full at pages 26 to 28.]

Filed T.C.U.S. November 10, 1947.

## [Title of Tax Court and Cause.]

## ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner admits and denies as follows:

1, 2 and 3. Admits the allegations contained in paragraphs 1, 2 and 3 of the petition.

4 and 4(a) to (e), inclusive. Denies that the Commissioner erred in the determination of the deficiency as alleged in paragraph 4 of the petition and subparagraphs (a) to (e), inclusive, thereunder.

5(a). Denies the allegations contained in subparagraph (a) of paragraph 5 of the petition.

(b). Admits the allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) and (d). Denies the allegations contained in subparagraphs (c) and (d) of paragraph 5 of the petition.

5(e). For lack of knowledge or information sufficient to form a belief, denies the allegations contained in subparagraph (e) of paragraph 5 of the petition.

(f), (g) and (h). For lack of knowledge or information sufficient to form a belief, denies the allegations contained in subparagraphs (f), (g) and (h) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ CHARLES OLIPHANT,  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

B. H. NEBLETT,  
Division Counsel;

T. M. MATHER,  
Special Attorney, Bureau  
Of Internal Revenue.

Received and Filed, T. C. U. S., December 16,  
1947.

---

[Title of Tax Court and Cause.]

## COMPUTATION FOR ENTRY OF DECISION

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and submits the attached computation of the deficiency under the opinion of The Tax Court of the United States promulgated December 22, 1949, in the above-entitled appeal.

The respondent's computation is submitted in accordance with Rule 50 of the Tax Court's Rules of

Practice and is without prejudice to his right to contest the correctness of the decision pursuant to the statute in such cases made and provided.

/s/ CHARLES OLIPHANT,  
Chief Counsel, Bureau of  
Internal Revenue.

Of Counsel:

B. H. NEBLETT,  
Division Counsel;

T. M. MATHER,  
Special Attorney,  
Bureau of Internal Revenue.

C:TS:PD

SF:TMM:BSF:Recomputation

### Audit Statement

In re: Floyd J. Harkness  
3767 Huntington Boulevard  
Fresno, California

Docket No. 16408

Deficiency letter, dated August 21, 1947

Income and Victory Tax

Year	Deficiency
1943	\$65,252.27

Recomputation of tax liability prepared in accordance with the memorandum opinion of The Tax Court of the United States promulgated December 22, 1949.



Floyd J. Harkness

Recomputation Statement

Year: 1943

Schedule 1

Adjustments to Net Income

	Income Tax Net Income	Victory Tax Net Income
Net income as shown in deficiency notice dated August 21, 1947 .....	\$180,137.54	\$186,520.93
Net income, adjusted .....	180,012.54	186,395.93
Adjustment .....	\$ 125.00	\$ 125.00
Nontaxable income:		
Business income .....	\$ 125.00	\$ 125.00

Schedule 2

Explanation of Adjustment

The net profit of United Packing Company for the year 1943 is determined to be \$361,582.00 as shown in the stipulation of facts instead of \$361,832.00 as shown in the deficiency notice. Adjustment of this discrepancy results in a net decrease in profits of \$250.00, of which petitioner's community-half is \$125.00.

Schedule 3

Computation of Tax

Income tax net income, Schedule 1.....	\$180,012.54
Less: Personal exemption .....	\$ 100.00
Credit for dependent .....	350.00 450.00
Surtax net income .....	\$179,562.54
Less: Earned income credit .....	1,400.00
Balance subject to normal tax .....	\$178,162.54
Normal tax at 6% on \$178,162.54.....	\$ 10,689.75
Surtax on \$179,562.54.....	122,585.66
Total income tax .....	\$133,275.41

## Schedule 3—(Continued)

Total income tax (brought forward) .....	\$133,275.41
Victory tax net income .....	\$186,395.93
Less: Specific exemption .....	624.00
Income subject to victory tax .....	\$185,771.93
Victory tax at 5% .....	\$ 9,288.60
Less: Victory tax credit .....	600.00
Net victory tax .....	8,688.60
Income and victory tax .....	\$141,964.01
Income tax for 1942 as shown in deficiency notice, unchanged .....	\$ 36,936.99
Income and victory tax liability (greater amount).....	\$141,964.01
Forgiveness feature:	
Income tax, 1942 .....	\$ 36,936.99
Less: Amount forgiven ( $\frac{3}{4}$ ) .....	27,702.74
Amount unforgiven .....	9,234.25
Total income and victory tax .....	\$151,198.26
Income and victory tax shown on return	
Original, Account No. 359237, First California District .....	85,945.99
Deficiency .....	\$ 65,252.27

Filed T.C.U.S. January 17, 1950.

The Tax Court of the United States  
Washington

Docket No. 16408

FLOYD J. HARKNESS,  
Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion promulgated December 22, 1949, the respondent herein filed a recomputation of tax on January 17, 1950. At the hearing on respondent's recomputation of tax held February 15, 1950, the petitioner did not appear. No objection has been filed to respondent's recomputation. It appearing that such recomputation is correct, it is, therefore, in accordance therewith,

Ordered and Decided: That there is a deficiency in income and victory tax for the year 1943 in the amount of \$65,252.27.

Entered Feb. 15, 1950.

[Seal]:       /s/ SAMUEL B. HILL,  
Judge.

Served Feb. 16, 1950.

[Title of Tax Court and Cause.]

PETITION OF FLOYD J. HARKNESS FOR  
REVIEW BY THE UNITED STATES  
COURT OF APPEALS FOR THE NINTH  
CIRCUIT OF A DECISION BY THE TAX  
COURT OF THE UNITED STATES

The taxpayer, Floyd J. Harkness, petitioner in this cause, by Philip S. Ehrlich, R. J. Hecht and Albert A. Axelrod, counsel for petitioner, hereby files his petition for review by the United States Court of Appeals for the Ninth Circuit of the decision by the Tax Court of the United States promulgated December 22, 1949, 13 T. C. No. 129, determining deficiencies in income and victory taxes of the petitioner for the calendar year 1943, which deficiencies against the petitioner Floyd J. Harkness, was in the sum of \$65,252.27, which deficiencies were determined by the Tax Court on February 15, 1950; and said petitioner respectfully shows:

I.

The petitioner resides, and at all the times mentioned in said petition resided, in the City of Fresno, County of Fresno, State of California. He filed his separate income tax return for the calendar year 1943 with the Collector of Internal Revenue for the 1st District of California at San Francisco, California.

II.

Nature of the Controversy

The controversy involves the proper determina-



tion of the petitioner's liability for Federal Income and Victory Taxes for the calendar year 1943. The determination of the deficiency against the petitioner arose by reason of the inclusion by the respondent in the petitioner's taxable income for the taxable year 1943, on a community property basis, of all the income from the operation of a partnership composed of the petitioner, Floyd J. Harkness, his wife, Molly A. Harkness, the petitioner's son, Floyd J. Harkness, Jr., and the petitioner's daughter, Harriet Harkness Colgate. This partnership does business under the firm name and style of United Packing Co. During the taxable year in question, each of the persons above named owned a 25% interest in the partnership.

In connection with the controversy the Tax Court found, in part, as follows:

"Petitioners, Floyd J. Harkness and Molly A. Harkness, are individuals residing in Fresno, California. They filed their separate income tax returns for 1943 with the Collector of Internal Revenue for the First District of California. Petitioners were married July 14, 1915, and have made their home in California ever since. They have two children, Floyd J. Harkness, Jr., and Harriet Harkness Colgate, born in 1918 and 1920, respectively.

Harkness, Sr. has been a grower and shipper of fruits and vegetables since 1918. Prior to 1937 he engaged in this occupation first as an employee of various concerns and then as a member of two successive partnerships operating under the name of United Packing Co. In January 1937, petitioner

bought out his partner and commenced operating the business as a sole proprietorship under the same name. Molly Harkness, as his wife, owned the assets of the business in community with him. The company specialized in packing and shipping cantaloupes, carrots, peaches, plums, nectarines and grapes. Some commodities were raised by the company itself while others were bought from farmers on a cash basis. Still other produce was packed and shipped by the company on a commission basis. For the purposes of its business, United Packing Co. operated ranches and packing houses, and manufactured and stocked packing materials. Its main office was located in Fresno, but its operations covered a large area in the San Joaquin Valley extending northward 138 miles to Lodi and southward 127 miles to Arvin. At the close of 1942 the gross proceeds and net income earned by United Packing Co. amounted to \$1,468,119.64 and \$141,790.95, respectively.

During the years up to 1942 petitioners' two children were occupied primarily in obtaining an education, though each performed some service in their father's business. Harkness, Jr. attended schools until June, 1941 when he graduated from college with a major in commerce. From 1934 until 1941 he worked in his father's business during summer vacations and in 1937 he quit school for six months to help his father launch the sole proprietorship. From June, 1941 until January, 1942 he devoted his full time as an employee of United Packing Co. working as a 'regular field man' at a salary of

\$150 per month plus a five per cent bonus of approximately \$910. During this six-months' period he also earned four to five thousand dollars in independent deals in the fruit and vegetable business. On January 12, 1942, he entered the United States Air Corps as a private. At the close of 1942 petitioners' son still had a credit on the books of the sole proprietorship of \$1,412.05 for prior services performed. He owned no substantial property outside of these earnings at that time.

Harriet Harkness finished her schooling in June, 1942 when she graduated from college. During summer vacations she had occasionally performed secretarial services in her father's business. Harriet worked full time as a secretary at United Packing Co. from June until August, 1942 at which time she married William H. Colgate, Jr., who was then serving in the United States Army. Following her marriage she spent her time housekeeping for her husband at various military posts in the United States until October, 1944. She owned no significant amount of property at the time of her marriage.

Harriet's husband, William Colgate, had resided in Fresno County, California, all his youth and had been an acquaintance of the Harkness family for a number of years prior to his marriage in 1942. He attended college, majoring in commerce, and during summer vacations was employed by Peerless Pump Company, the largest supplier of irrigation pumps in the San Joaquin Valley. Colgate later quit school and worked full time for this company



for nine months before enlisting in the United States Army in March, 1941. This was in keeping with his desire to devote his career to agricultural pursuits in the Valley. As an assistant foreman aiding in the installation of extensive irrigation systems, Colgate acquired considerable knowledge of the mechanics of irrigation. After his marriage to Harriet, they were stationed at Columbus, Ohio, during the latter part of 1942 and throughout 1943.

In the fall of 1942 Harkness, Sr. became convinced that it would be advantageous to convert the operation of his fruit packing and shipping business from a sole proprietorship to a partnership composed of his wife, himself and his two children in the coming year. Many reasons dictated that decision. Primarily he desired to obtain the services of his son and son-in-law in the business. He felt that as a result of their college education and the practical experience they had gained pursuing agricultural employment in the Valley that they would make skilled, competent supervisors capable of overseeing the widespread operations of the company. Secondly, from his experience in the fruit and vegetable packing industry, Harkness believed that it was essential to increase the capital investment in the company by allowing annual profits to remain in the business. This was necessary not only to permit payment of extensive operating expenses, to allow for expansion of company facilities and equipment and to develop new business, but also to meet the exigencies of bad crop years when the com-



pany's income declined drastically. Furthermore, in 1942 fruit packers were anticipating a decline in profits due to labor shortages, low transportation priorities for their produce, and the probability that prices would tumble as in World War I. These circumstances only increased the need for increasing the capital reserve of United Packing Co. Yet it had been Harkness' experience in past years that to hold qualified supervisory personnel it was necessary to pay them large bonuses or percentages of profits which they invariably withdrew from the business and often used to set themselves up in competition with him, thus draining the company's capital. He felt the only way to retain profits in the company was to bring into the business persons who felt as he did. Through long discussions with Harkness, Jr. and William Colgate, petitioner knew that they agreed with him that only a reasonable amount of the profits should be withdrawn from United Packing Co. and the rest of the net income should be allowed to accumulate in the business.

While Harkness, Sr. was well aware that neither Floyd, Jr., nor William Colgate would be available to serve United Packing Co. for the duration of the war and he would be the only active partner in the meantime, yet he desired them to acquire an interest in the company at this time to guarantee their future help in running the business after their release from the Army.

Furthermore, formation of the partnership accorded with the wish of Harkness, Sr. to give his children an opportunity to make good. Even when

Floyd, Jr. was a boy he and his father planned for the day when the former would be a full-fledged partner. After graduation from college in 1941 Harkness, Jr. had pressed his father to give him the status of a partner in the business, and while Harkness, Sr. had too many financial commitments to do so in that year, yet he promised his son he would make provision for him to purchase an interest in the business. Now petitioner desired to fulfill that promise. It was long understood that if one child was given an opportunity to participate in the business, the other would be given an equal opportunity. Offering Harriet an opportunity to become a partner in his business not only fulfilled this pledge, but was a long step toward securing the eventual services of her husband which petitioner so greatly desired.

While Harkness, Sr. consulted a lawyer concerning the feasibility of converting his business into a partnership and was thus aware of the tax saving possibilities inherent therein, yet this fact was only a secondary consideration with him, and he would have entered into this arrangement regardless thereof.

During the fall of 1942 Harkness, Sr. held lengthy conversations with his son, who was stationed at a nearby airfield, regarding the proposed partnership. Harkness, Jr. eagerly accepted the chance to buy an interest in United Packing Co. for this had been his great desire for many years and assured him of full participation in the business on his re-

turn from the service. Petitioners and young Harkness then definitely planned to convert the business into a partnership starting in 1943.

Over the same period of time Harkness, Sr. also corresponded with his daughter and offered her either the opportunity to invest in United Packing Co. or some other enterprise. Furthermore, it was understood that if she decided to come into her father's business, her husband, William Colgate, would be allowed to participate in the partnership following his release from the Army. Harriet and William Colgate debated at length whether it was advisable for her to buy an interest in her father's business or invest elsewhere. Finally Harriet exercised her option to procure an interest in United Packing Co. after her husband determined he wanted to be associated with United Packing Co. upon his return from the service.

Thus by November, 1942 petitioners and both their children generally agreed to the formation of a partnership for the operation of United Packing Co. in the coming year, though the details of the partnership relationship had not been worked out. A "Certificate of Co-Partnership Transacting Business under Fictitious Name" was executed on November 12, 1942, which petitioners and young Harkness signed on that date and Harriet signed on November 28. It stated that the four were co-partners carrying on business under the name of United Packing Co. and that Harkness, Sr., was the general manager in full charge of all business operations. This certificate was published in a



local paper and later filed with the County Recorder of Fresno County.

On December 31, 1942, "Articles of Partnership," providing the detailed terms of the proposed partnership, were drafted and met the approval of all but Harriet Colgate, who refused to sign until provisions as to control of the business and as to purchase of a deceased partner's share were modified.

On January 1, 1943, petitioners transferred to United Packing Co., a partnership, most of the assets and some of the liabilities of United Packing Co., sole proprietorship, existing on December 31, 1942, resulting in a net worth of \$138,241.61 for the partnership on that date. Harkness, Jr. and Harriet Colgate each bought a one-fourth interest in the partnership for \$34,560.41, equivalent to one-fourth of its net worth. To pay Harkness, Sr. for his share in the partnership the son used \$1,392.05 of the credit he had earned as compensation for prior services rendered the sole proprietorship and on January 2, 1943, signed a promissory note for the remaining \$33,168.35 with interest at four per cent per annum. Harriet Colgate purchased her partnership interest from her father with a promissory note dated January 2, 1943, for \$34,560.40 plus four per cent interest per annum. William Colgate joined her on the note as co-maker. No collateral was required on either note.

These transactions were reflected on the books of United Packing Co., co-partnership, as of January 1, 1943. It showed assets of \$142,861.03 and



liabilities of \$4,619.92 and a net worth of \$138,241.61. Capital of the partnership was stated to be \$138,241.61 resulting from contributions of \$34,560.41 each from the three Harknesses and Harriet Colgate.

On January 4, 1943, pending acceptance by Harriet Colgate of the articles of partnership drafted on December 31, 1942, Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate signed a supplemental agreement fixing compensation and distribution of partnership profits among the partners. The salary of Harkness, Sr., as general manager of the partnership, was fixed at 75 per cent of the first \$100,000 of the partnership net income. There was no provision for salaries for the other partners. The remainder of the first \$100,000 of partnership net income was to be divided equally among the partners, as were any profits over that amount.

\* \* \*

During January, 1943, Harkness, Sr. discussed with the Colgates the modifications sought by Harriet Colgate in the partnership agreement drafted on December 31, 1942. Harriet withdrew her objections when the original draft was altered to meet her demands. The reformed partnership agreement was signed by the three Harknesses on February 27, 1943, and by Harriet Colgate on March 10, 1943.

\* \* \*

In February, 1943, an undivided one-half interest

in a 300-acre vineyard and orchard was acquired by Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate as tenants in common. The other half interest in the ranch was acquired by Chris Sorenson and his wife. Sorenson was a supervisory employee of United Packing Co. All funds for purchase of the vineyard were supplied by United Packing Co. and the amount loaned to Sorenson was repaid to the company by him. The 50 per cent interest acquired by the Harknesses and Harriet Colgate was included as an asset of United Packing Co. and subsequent income therefrom was included in its net income. Previously on January 16, 1943, by a bill of sale the personal property on the River Ranch had been conveyed to Chris A. Sorenson and Katharine Sorenson, his wife, and "Floyd J. Harkness, Molly A. Harkness, Harriet Harkness Colgate and Floyd J. Harkness, Jr., co-partners, doing business under the firm name and style of United Packing Co., a co-partnership." Prior to these purchases, all the partners were consulted with respect to them, and Harkness, Jr., who was familiar with the land, approved the transactions.

During the year 1943 there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr. Harriet and William Colgate were absent from Fresno until his discharge from the armed services in October 1944, so consequently she performed no services for United Packing Co. during the year 1943 nor did she participate in the

management of its affairs. Throughout the year 1943 until December, Harkness, Jr. was stationed at Hamilton Field, California, approximately six hours traveling time from Fresno, and frequently visited the company's office and packing plants on weekends. While he was unable to participate in the business activities, yet he discussed its problems with his father on these occasions. In December, 1943 Harkness, Jr. went overseas with the Air Corps and did not return to Fresno until January, 1946.

In 1943 United Packing Co. earned gross proceeds of \$2,572,905.53 and a net income of \$361,582. In accordance with the terms of the supplemental agreement Harkness, Sr. was paid a salary of \$75,000 and Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate each were credited with \$71,645.50 as their respective shares of the profits.

Harriet's credit on the partnership books was first applied to pay off the principal and interest on her promissory note to Harkness, Sr., in the amount of \$35,942.82, and to offset prior withdrawals from her capital account consisting of cash in the amount of \$112.97 and sums of \$1,070.89 and \$31,423.67 paid to the Collector of Internal Revenue. The balance of \$3,095.15 which she left in the business at the close of 1943 was withdrawn in 1944 to pay for taxes and personal expenditures. Of the \$71,645.50 credited to Harkness, Jr., \$34,495.08 was turned over to his father to pay the principal and interest on his promissory note. Of the remaining \$37,150.42 which he left in the business in 1943, young



Harkness expended \$331.58 for his own use in 1944.

United Packing Co. filed a partnership return for the year 1943, reporting a net income of \$361,582, compensation of \$75,000 paid to Harkness, Sr., and the distribution of \$71,645.50 from profits to each of the three Harknesses and to Harriet Colgate.

Harkness, Sr. and Molly Harkness filed separate income tax returns in 1943. As residents of a community property state, each reported one-half of the total income of \$218,291 they together received from United Packing Co. in 1943, or \$109,145.50.

In his notices of deficiency sent to petitioners, respondent determined that the net income of United Packing Co. for 1943 was \$361,823 and that each petitioner realized one-half of this amount, or \$180,916, as community property income. The notice of deficiency sent to Harkness, Sr. stated in part:

“(a) On December 31, 1942, you and your wife, Molly A. Harkness, together with your two children, Floyd James Harkness, Jr. and Harriet Harkness Colgate, executed an instrument purporting to create a family partnership. Since Floyd James Harkness, Jr. and Harriet Harkness Colgate contributed no capital originating with themselves, rendered no services to the business, and were not required to participate in the control and management of the business under the terms of the alleged partnership agreement, it is held that they did not acquire valid partnership interests in the United Packing Company. Accordingly, profits



from the above-named organization are reallocated to you and your wife on a community property basis, thus increasing your taxable income by \$71,770.50 as shown below.

Total net profit of United Packing

Company .....	\$361,832.00
Your community one-half share .....	180,916.00
Amount reported on return .....	109,145.50

---

Adjustment—Increase .....\$ 71,770.50''

Similar language was contained in the notice of deficiency received by Molly Harkness.

The three Harknesses and Harriet Colgate had no intent to join together in conducting the business of United Packing Company as bona fide partners in 1943 and thus their partnership was not valid for tax purposes in that year."

The Tax Court, in its opinion, held that the petitioner, his wife, and their children had no intent to join together in conducting the business of United Packing Co. as bona fide partners in 1943, and that their partnership was not valid for tax purposes in that year.

### III.

The said taxpayer, to wit, Floyd J. Harkness, being aggrieved by the Findings of Fact and Conclusions of Law contained in said Findings and Opinions of the Court and by the Tax Court's decisions entered pursuant thereto, desires to obtain a review thereof by the United States Court of Appeals for the Ninth Circuit.

## IV.

The petitioner assigns as error the following acts and omissions of the Tax Court of the United States:

1. The Tax Court erred in finding contrary to the record that:

“During the year 1943 there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr.”

2. The Tax Court erred in finding contrary to the record that no collateral was required to secure the notes given by Harriet Colgate and Floyd J. Harkness, Jr., to petitioner and his wife.

3. The Tax Court erred in finding contrary to the record as a whole that:

“The three Harknesses and Harriet Colgate had no intention to join together in conducting the business of United Packing Co. as bona fide partners in 1943 and thus their partnership was not valid for tax purposes in that year.”

4. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., upon his return from the Army in January, 1946, was appointed Assistant General Manager of the partnership business, and has ever since that time, and up to January 11, 1949, the date of the hearing of this case, rendered substantial managerial services to the business.

5. The Tax Court erred in not finding, as the record shows, that during the year 1946 Floyd J. Harkness, Jr. received the sum of \$57,984.85, and during the year 1947 the sum of \$53,635.13, as salary for each of said years for services rendered as such Assistant General Manager.

6. The Tax Court erred in not finding, as the record shows, that during the period 1946 to 1947, Floyd J. Harkness, Jr. withdrew from the partnership business a total sum of \$121,484.51.

7. The Tax Court erred in not finding, as the record shows, that William Colgate was discharged from the Army in the Fall of 1944, and immediately went to work for the partnership, and in not finding that in January, 1945, William Colgate became a fifth partner in the enterprise.

8. The Tax Court erred in not finding, as the record shows, that William Colgate has ever since January, 1945, been the Manager of the Clovis-Sanger District of the partnership and has rendered substantial services of a supervisory and managerial nature to the partnership, and in not finding that he has received the following compensation for his services: 1944, \$450.00; 1945, \$5,275.00; 1946, \$46,554.79; 1947, \$35,928.45.

9. The Tax Court erred in not finding, as the record shows, that during the period 1944 to 1947, William Colgate and Harriet Colgate have withdrawn \$100,138.48 from the partnership.



10. The Tax Court erred in not finding, as the record shows, as a whole, that Floyd J. Harkness, Jr., and Harriet Colgate were and have been ever since January 1, 1943, the true owners of an undivided interest in the assets of the partnership.

11. The Tax Court erred in not finding, as the record shows as a whole, that Floyd J. Harkness, Jr. and William Colgate made, as of the date of the formation of the partnership, a commitment to render services to the partnership as soon as circumstances permitted.

12. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., Harriet Colgate and petitioner and his wife were co-owners, tenants in common, of one-half of the Ranch known as the "River Ranch," each owning an undivided  $\frac{1}{8}$  interest therein, and in not finding that during the year 1943 the profits derived from the operation of this Ranch amounted to \$60,309.92, and in not finding that the  $\frac{1}{8}$ th interest of each of the children yielded an income belonging to them in the sum of \$15,077.48 each.

13. The Tax Court erred in not finding, as the record shows, that Harriet Colgate and Floyd J. Harkness, Jr. pledged the first income to be derived from the business of the partnership to the payment of the notes given by them to petitioner and his wife.

14. The Tax Court erred in not finding, as the record shows, that petitioner and his wife and Har-



riet Colgate and Floyd J. Harkness, Jr., intended to join together in conducting the business of United Packing Co. as bona fide partners in 1945 and that their partnership was valid for tax purposes for that year.

15. The Tax Court erred in that its decision herein is contrary to the applicable decisions of the Supreme Court of the United States.

16. The Tax Court erred herein in that its decision is contrary to the applicable decisions of the Tax Court heretofore made.

17. The Tax Court erred in finding, contrary to the record, a deficiency for the year 1943, in lieu of a finding that there is no income tax due from the petitioner for said year.

Wherefore, petitioner prays for a review by the United States Court of Appeals for the Ninth Circuit of the decision by the United States Tax Court, promulgated December 22, 1949, 13 T.C. No. 129; and that upon such review said Honorable Court make and enter a decree setting aside and reversing said decision of the United States Tax Court, and determine that the respondent, the Commissioner of Internal Revenue, erred in reallocating the income of the partnership known as United Packing Co. and in such reallocation reallocating to the petitioner, named Floyd J. Harkness, Sr., and to his wife, Molly A. Harkness, on a community property basis, the entire income from said partnership; and should further determine that there was no de-

ficiency in income taxes or victory taxes for the year 1943 from said petitioner.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Counsel for Petitioner.

State of California,

City and County of San Francisco—ss.

Albert A. Axelrod and R. J. Hecht, being first duly sworn, depose and say:

That they are counsel of record in the above-entitled cause; that as such counsel they are authorized to verify the foregoing petition for review, that they have read said petition and are familiar with the statements contained therein; that the statements made are true to the best of each of their knowledge, information and belief.

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT.

Subscribed and sworn to before me this 10th day of May 1950.

[Seal] /s/ GLADYS C. OKERSTROM,  
Notary Public in and for the City and County of  
San Francisco, State of California.

My Commission Expires October 27, 1952.

Received and Filed, T.C.U.S., May 12, 1950.

In the United States Court of Appeals  
For the Ninth Circuit

Docket No. 16408

FLOYD J. HARKNESS,

Petitioner on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent on Review.

NOTICE OF FILING PETITION  
FOR REVIEW

To: Charles Oliphant,  
Chief Counsel,  
Bureau of Internal Revenue.

You are hereby notified that the above-petitioner did, on the 12th day of May, 1950, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit, of the decision of this Court heretofore rendered in the above-entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this 16th day of May, 1950.

/s/ VICTOR S. MERSCH,

Clerk, The Tax Court of the  
United States.

Service of Copy of Petition for Review Acknowledged this 16th day of May, 1950.

/s/ CHARLES OLIPHANT,  
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

Filed T.C.U.S. May 16, 1950.

---

In the Tax Court of the United States  
No. 16408

FLOYD J. HARKNESS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

PRAECIPE FOR RECORD

To the Clerk of the Tax Court of the United States:

You are hereby respectfully requested to prepare and certify and transmit to the Clerk of the United States Court of Appeals for the Ninth Circuit, with reference to Petition for Review heretofore filed by the petitioner in the above-entitled cause, a transcript of record in the above cause prepared and transmitted as required by law and by the rules of said court, and to include in said transcript of record the following documents or certified copies thereof, to wit:



1. The docket entries of all proceedings before the Tax Court.

2. Pleadings before the Tax Court of the United States as follows:

(a) Petition for redetermination.

(b) Answer of respondent.

3. Stipulation of facts filed at the hearing January 11, 1949.

4. Reporter's transcript of the proceedings and testimony before the Tax Court on January 11, 1949.

5. The following exhibits introduced in evidence before the Tax Court on January 11, 1949:

(a) Joint exhibits: 10-J, 11-K, 12-L.

(b) Petitioner's exhibits: 13, 14, 15, 16, 17, 18.

(c) Respondent's exhibits M, N.

6. Notice under Rule 50.

7. Respondent's computation for entry of decision.

8. Stipulation signed by counsel for petitioner with respect to the computation of respondent.

9. Decision of the Tax Court.

10. Petition for Review filed by petitioner.

11. This praecipe.

12. Notice of Filing Petition for Review.

Dated: July 10, 1950.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Attorneys for Petitioner,  
Floyd J. Harkness.

Affidavit of Service by Mail attached.

Received and Filed, T.C.U.S., July 12, 1950.

---

[Title of Tax Court and Cause.]

### CERTIFICATE

I, Victor S. Mersch, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 3, inclusive, constitute and are all of the original papers and proceedings on file in my office with the exception of the original stenographic transcript of hearing and exhibits, which are incorporated in the related case Docket No. 16407, as called for by the "Praecipe for Record" in the proceeding before the Tax Court of the United States entitled: "Floyd J. Harkness, Respondent," Docket No. 16408, and in which the petitioner in the Tax Court proceeding has initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court proceeding, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 14th day of April, 1950.

[Seal]      /s/ VICTOR S. MERSCH,  
Clerk.

The Tax Court of the United States

---

[Endorsed]: No. 12619. United States Circuit Court of Appeals for the Ninth Circuit. Floyd J. Harkness, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record Upon Petition to Review a Decision of The Tax Court of the United States.

Filed July 19, 1950.

      /s/ PAUL P. O'BRIEN,  
Clerk of the United States Circuit Court of  
Appeals for the Ninth Circuit.

In the United States Court of Appeals  
for the Ninth Circuit

No. 12619

FLOYD J. HARKNESS,

Petitioner and Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent and Appellee.

APPLICATION FOR EXTENSION OF TIME  
WITHIN WHICH TO FILE RECORD AND  
DOCKET CASE ON A PETITION FOR  
REVIEW FROM A DECISION OF THE  
TAX COURT OF THE UNITED STATES

To the Honorable Justices of the United States  
Court of Appeals for the Ninth Circuit:

The above-named petitioner Floyd J. Harkness, through his counsel, hereby applies to this Honorable Court for an extension of time within which to file the record and docket his case after filing of the petition for review in the Tax Court of the United States.

This application is made on the ground of excusable neglect of one of counsel for said petitioner, in failing to file with the Clerk of the Tax Court of the United States a praecipe designating the record to be transmitted to the Clerk of this Honorable Court, within the forty-day period called for by Rule 31 of this Honorable Court.



This application is supported by the affidavit of R. J. Hecht, one of counsel for petitioner, and points and authorities likewise attached to this application.

Petitioner respectfully requests that he be granted a reasonable time within the discretion of the above-entitled court within which the Clerk of the Tax Court may file with the Clerk of this Honorable Court said record, and within which said case may be docketed.

Dated: July 7, 1950.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Attorneys for Petitioner and Appellant Floyd J.  
Harkness.

Ordered time of petitioner to file transcript of record and docket cause extended to August 1, 1950.

/s/ WILLIAM HEALEY,

/s/ WM. E. ORR,

/s/ WALTER L. POPE,

U. S. Circuit Judges.

[Endorsed]: Filed July 8, 1950.

[Title of Court of Appeals and Cause.]

STATEMENT OF POINTS ON WHICH APPELLANT INTENDS TO RELY AND DESIGNATION OF PARTS OF THE RECORD NECESSARY FOR CONSIDERATION THEREOF

Appellant proposes, on his appeal, to rely on the following points:

1. The following ultimate finding of the Tax Court is contrary to its evidentiary findings:

“The three Harknesses and Harriet Colgate had no intent to join together in conducting the business of United Packing Co. as bona fide partners in 1943 and thus their partnership was not valid for tax purposes in that year.”

2. The ultimate finding set forth in 1 above is based upon a misapplication of the law.

3. The ultimate finding set forth in 1 above is clearly erroneous because it is against the clear weight of the evidence and is arrived at by accepting part of the evidence and totally disregarding other convincing evidence.

4. The following finding of fact is clearly erroneous because it is against the clear weight of the evidence and is arrived at by accepting part of the evidence and totally disregarding other convincing evidence:

“During the year 1943 there was no change in the operation of United Packing Co. over

prior years. The business was still completely under the control of Harkness, Sr.”

5. The following ultimate finding of the Tax Court is contrary to its evidentiary findings:

“No collateral was required on either note.”

6. The ultimate finding set forth in 5 above is clearly erroneous because it is against the clear weight of the evidence.

7. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., upon his return from the Army in January, 1946, was appointed Assistant General Manager of the partnership business, and has ever since that time, and up to January 11, 1949, the date of the hearing of this case, rendered substantial managerial services to the business.

8. The Tax Court erred in not finding, as the record shows, that during the year 1946 Floyd J. Harkness, Jr. received the sum of \$57,984.85, and during the year 1947 the sum of \$53,635.13, as salary for each of said years for services rendered as such Assistant General Manager.

9. The Tax Court erred in not finding, as the record shows, that during the period 1946 to 1947 Floyd J. Harkness, Jr. withdrew from the partnership business a total sum of \$121,484.51.

10. The Tax Court erred in not finding, as the record shows, that William Colgate was discharged from the Army in the Fall of 1944, and immediately went to work for the partnership, and in not finding



that in January, 1945, William Colgate became a fifth partner in the enterprise.

11. The Tax Court erred in not finding, as the record shows, that William Colgate has ever since January, 1945, been the Manager of the Clovis-Sanger District of the partnership and has rendered substantial services of a supervisory and managerial nature to the partnership, and in not finding that he has received the following compensation for his services: 1944, \$450.00; 1945, \$5,275.00; 1946, \$46,554.79; 1947, \$35,928.45.

12. The Tax Court erred in not finding, as the record shows, that during the period 1944 to 1947 William Colgate and Harriet Colgate have withdrawn \$100,138.48 from the partnership.

13. The Tax Court erred in not finding, as the record shows, as a whole, that Floyd J. Harkness, Jr. and Harriet Colgate were and have been ever since January 1, 1943, the true owners of an undivided interest in the assets of the partnership.

14. The Tax Court erred in not finding, as the record shows as a whole, that Floyd J. Harkness, Jr. and William Colgate made, as of the date of the formation of the partnership, a commitment to render services to the partnership as soon as circumstances permitted.

15. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., Harriet Colgate, and appellant and his wife, Molly A. Harkness, were co-owners, as tenants in common, of one-half of the Ranch known as the "River Ranch", each owning an undivided  $\frac{1}{8}$ th interest therein, and



in not finding that during the year 1943 the profits derived from the operation of this Ranch amounted to \$60,309.92, and in not finding that the 1/8th interest of each of the children yielded an income belonging to them in the sum of \$15,077.48 each.

16. The Tax Court erred in not finding, as the record shows, that Harriet Colgate and Floyd J. Harkness, Jr. pledged the first income to be derived from the business of the partnership to the payment of the notes given by them to appellant and his wife.

17. The Tax Court erred in not finding, as the record shows, that appellant and his wife and Harriet Colgate and Floyd J. Harkness, Jr. intended to join together in conducting the business of United Packing Co. as bona fide partners in 1945 and that their partnership was valid for tax purposes for that year.

18. The Tax Court erred in that its decision herein is contrary to the applicable decisions of the Supreme Court of the United States. (Commissioner of Internal Revenue v. Culbertson, 337 U.S. 733; Commissioner of Internal Revenue v. Tower, 327 U.S. 280).

19. The Tax Court erred herein in that its decision is contrary to the applicable decisions of the Tax Court heretofore made. (Isaac Blumberg, 11 T.C. 663).

20. The Tax Court erred in finding, contrary to the record, a deficiency for the year 1943, in lieu of a finding that there is no income tax due from appellant for said year.

Appellant designates the following portions of the record as necessary for the consideration of the foregoing points:

- (a) The petition of Floyd J. Harkness.
- (b) Answer of Commissioner of Internal Revenue.
- (c) Respondent Commissioner's petition for entry of decision.
- (d) Decision.
- (e) Petition for review.
- (f) Proof of service of petition for review.
- (g) Application and order re extension of time to transmit record. (Please omit affidavit in support of application and points and authorities).
- (h) Praecipe for record.
- (i) Certificate of Clerk of Tax Court of the United States.
- (j) This statement of points on which appellant intends to rely and designation of parts of the record necessary for consideration thereof.

Dated at San Francisco, California, July 24, 1950.

/s/ PHILIP S. EHRLICH,

/s/ ALBERT A. AXELROD,

/s/ R. J. HECHT,

Attorneys for appellant  
Floyd J. Harkness

[Endorsed]: Filed July 25, 1950.

[Title of Court of Appeals and Cause.]

STIPULATION FOR CONSOLIDATION ON  
PETITION FOR REVIEW

It Is Hereby Stipulated by and between the parties, through their respective counsel, that the above-entitled cause be consolidated with the case of Molly A. Harkness, Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 12618, and that for the purposes of said consolidated petitions the parties will rely upon the record in the Molly A. Harkness, Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 12618.

It Is Likewise Stipulated by and between the parties, through their respective counsel, that the petitions for review in this cause, and in the cause of Molly A. Harkness, Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 12618, be consolidated for the purposes of brief, argument and opinion.

Dated: August 11, 1950.

/s/ THERON L. CAUDLE,  
Assistant Attorney General.

.....

Charles Oliphant,  
Attorneys for Respondent.

/s/ PHILIP S. EHRLICH,  
/s/ ALBERT A. AXELROD,  
/s/ R. J. HECHT,  
Attorneys for Petitioner.

It Is Ordered: That the above causes be consolidated for brief and argument.

/s/ WILLIAM DENMAN,  
Judge of the United States  
Court of Appeals.

/s/ CLIFTON MATHEWS,

/s/ WILLIAM HEALY,  
Judges, U. S. Court of  
Appeals for the 9th Circuit.

[Endorsed]: Filed August 17, 1950.



Nos. 12,618 and 12,619

IN THE

United States Court of Appeals  
For the Ninth Circuit

MOLLY A. HARKNESS,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent,*

No. 12,618

(CONSOLIDATED  
CASES)

FLOYD J. HARKNESS,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

No. 12,619

BRIEF FOR PETITIONERS.

PHILIP S. EHRLICH,

ALBERT A. AXELROD,

R. J. HECHT,

IRVING ROVENS,

2002 Russ Building, San Francisco 4, California,

*Attorneys for Petitioners.*

FILED

MAY 10 1950

	Page
C. The Tax Court erred in not giving any consideration to the good faith of the parties and in substituting its judgment for that of the petitioners in appraising the value of the consideration given by the children for their interest in the partnership .....	46
III.	
The Tax Court erred in making findings and conclusions that are contrary to the record and in failing to consider and make findings on evidence showing the conduct of the parties in years subsequent to the tax year in question....	54
A. It was error for the Tax Court to disregard undisputed and convincing evidence disclosing the bona fide performance of the partnership agreement .....	54
B. The Tax Court erred in finding that during the year 1943 the business of the partnership was still completely under the control of Harkness, Sr. This finding is contrary to the record and fails to give effect to the intent and good faith of the parties .....	58
C. The Tax Court erred in concluding that petitioners' children did not have unhampered enjoyment of their respective shares of the proceeds of the business. This conclusion is unreasonable and contrary to the record	76
Conclusion .....	79

## Table of Authorities Cited

Cases	Pages
Blumberg v. Commissioner, 11 T. C. 663 (1948) .....	31
Chance v. Kobested, 66 Cal. App. 434, 226 P. 632 (1924) ..	64
Commissioner v. Culbertson, 337 U.S. 733, 93 L.Ed. 1659 (1949) .....	17, 26, 35, 39, 40, 52, 57
Commissioner v. Tower, 327 U.S. 280, 90 L.Ed. 670 (1946) .....	26, 31, 35, 57
Culbertson v. Commissioner, 9 T.C.M. 647 (1950) .....	41, 45, 46, 52, 62
Dobson v. Commissioner, 321 U.S. 231, 88 L.Ed. 691 (1944)	36
Estate of Gillette v. Commissioner, 182 F. (2d) 1010 (C.A. 9, 1950) .....	37
Estate of Sullivan v. Commissioner, 175 F. (2d) 657 (C.A. 9, 1949) .....	36
George Bros. & Co. v. Commissioners, 41 B.T.A. 287 (1940)	68
Grace Bros. v. Commissioner, 173 F. (2d) 170 (C.A. 9, 1949)	36
Grayson v. Deal, 85 F. Supp. 431 (N.D., Ala., S.D., 1949)	55
Greenberger v. Commissioner, 177 F. (2d) 990 (C.A. 7, 1949) .....	49, 72
Helvering v. Horst, 311 U.S. 112, 85 L.Ed. 75 (1940) .....	78
Hirsch v. Commissioner, 7 T.C.M., 932 (1948) .....	31
J. A. Riggs Tractor Co. v. Commissioner, 6 T.C. 889 (1946)	69
Lusthaus v. Commissioner, 327 U.S. 293, 90 L.Ed. 679 (1946) .....	31, 35, 38
Lyon v. MacQuarrie, 46 Cal. App. (2d) 119, 116 Pac. (2d) 549 (1941) .....	68
N.L.R.B. v. Union Pacific Stages, 99 F. (2d) 153, (C.C.A. 9, 1938) .....	58
Tindall v. Commissioner, 14 T.C. No. 125 (1950) .....	53

<b>Statutes</b>	<b>Pages</b>
Act of June 25, 1948, Section 36 (Public Law 773, 80th Cong., 2nd Sess., 62 Stat. 646) .....	36
<b>California Civil Code:</b>	
Section 172 .....	63, 64
Section 172a .....	64
Section 2419 .....	66
<b>Internal Revenue Code:</b>	
26 U.S.C.A., Section 11 .....	29
26 U.S.C.A., Section 22(a) .....	29
26 U.S.C.A., Section 181 .....	30
26 U.S.C.A., Section 182(c) .....	30
Section 1141 .....	2
Section 1141(a) .....	36
Section 1142 .....	36

### **Rules**

Federal Rules of Civil Procedure, Section 52(a) .....	36, 37
---	--------

### **Texts**

47 C. J., Partnerships, Section 46, page 654 .....	52
37 C. J. S., Fraudulent Conveyances, Section 148, page 969 .....	52



Nos. 12,618 and 12,619

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

---

MOLLY A. HARKNESS,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

No. 12,618

(CONSOLIDATED  
CASES)

FLOYD J. HARKNESS,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

No. 12,619

**BRIEF FOR PETITIONERS.**

---

**STATEMENT OF JURISDICTION.**

This matter comes before this Court on the petition for review of Molly A. Harkness (R. 285-303) of a decision by the Tax Court of the United States (R. 249-284) determining deficiencies in income and victory taxes for the calendar year 1943, which deficiencies against the Petitioner, Molly A. Harkness, were in the sum of Sixty-four Thousand Six Hundred Sixty-six Dollars and Sixty-four Cents (\$64,666.64), and

the petition for review of Floyd J. Harkness (R. 16-34) of a decision by the Tax Court of the United States (R. 15) determining deficiencies in income and victory taxes for the calendar year 1943, which deficiencies against the Petitioner, Floyd J. Harkness, were in the sum of Sixty-five Thousand Two Hundred Fifty-two Dollars and Twenty-seven Cents (\$65,252.27).

It was stipulated by and between the parties, through their respective counsel, that these petitions be consolidated, and that for the purposes of said consolidated petitions the parties will rely upon the record in "*Molly A. Harkness, Petitioner, vs. Commissioner of Internal Revenue, Respondent*", No. 12618 (R. 316).

It was further stipulated by and between the parties, through their respective counsel, that these petitions be consolidated for the purposes of brief, argument and opinion (R. 316-317).

#### **Opinion Below.**

The opinion and decision of the Tax Court is reported in 13 T.C. 1039, and is set forth at length on pages 249 to 284 of the Record.

#### **Jurisdiction.**

Jurisdiction and venue in this Court are predicated upon Sections 1141, as amended, and 1142, Internal Revenue Code. These petitions for review were filed on May 12, 1950 (R. 304), within three months after the Tax Court's decision on February 15, 1950 (R. 284).

Petitioners' income tax returns for the calendar year 1943 were filed with the Collector of Internal Revenue for the First District at San Francisco, California (R. 250).

Jurisdiction of the Tax Court is predicated upon Sections 272(a) and 1101, Internal Revenue Code. The petitions for redetermination were filed on November 10, 1947 (R. 28), within ninety days after Respondent's notices of deficiencies to Petitioners were mailed on August 21, 1947 (R. 9).

---

#### **STATEMENT OF THE CASE.**

The Petitioners are husband and wife. They are residents of Fresno, Fresno County, California (R. 105).

On August 21, 1947, the Respondent determined deficiencies in income tax liability for the taxable year ended December 31, 1943, against the Petitioners in the aggregate amount of One Hundred Twenty Thousand One Hundred Forty-eight Dollars and Ninety-one Cents (\$120,148.91) (R. 250).

This determination arose by reason of the inclusion by the Respondent in the Petitioners' taxable income for the taxable year 1943, on a community property basis, of all of the income from the operation of a partnership composed of Petitioners, their son, Floyd J. Harkness, Jr., and their daughter, Harriet Harkness Colgate (R. 272-273). This partnership does business under the firm name and style of United Packing Co.

During the taxable year in question, each of the partners owned a twenty-five per cent interest in the partnership.

After the Respondent had made his determination of deficiencies, the Petitioners applied to the Tax Court for redetermination. The Tax Court heard Petitioners' petitions for redetermination on January 11, 1949 (R. 82). The petitions were consolidated for hearing (R. 83), and were submitted to the Tax Court for decision upon a written stipulation of facts (R. 30-36), the oral testimony of four witnesses and certain Exhibits. After having considered the evidence, the Tax Court affirmed the Respondent's determination.

The sole issue is whether a valid and bona fide partnership existed between Petitioners and their children for the taxable year 1943 for Federal income tax purposes.

In the summary of the facts that follows, we have incorporated verbatim the findings of fact of the Tax Court. We have, however, in so doing, deleted ultimate findings and conclusions which are clearly erroneous. These deletions will be indicated where they occur by asterisks and the deleted material will be set forth in footnotes. In order to complete the summary, we have added at the conclusion of the Tax Court's findings, material facts with respect to which the Tax Court made no findings.



**Summary of the Facts.****(a) The Facts Found by the Tax Court.**

“Petitioners, Floyd J. Harkness and Molly A. Harkness, are individuals residing in Fresno, California. They filed their separate income tax returns for 1943 with the Collector of Internal Revenue for the First District of California. Petitioners were married July 14, 1915, and have made their home in California ever since. They have two children, Floyd J. Harkness, Jr., and Harriet Harkness Colgate, born in 1918 and 1920, respectively” (R. 250-251).

“Harkness, Sr., has been a grower and shipper of fruits and vegetables since 1918. Prior to 1937 he engaged in this occupation first as an employee of various concerns and then as a member of two successive partnerships operating under the name of United Packing Co. In January, 1937, Petitioner bought out his partner and commenced operating the business as a sole proprietorship under the same name. Molly Harkness, as his wife, owned the assets of the business in community with him. The company specialized in packing and shipping cantaloupes, carrots, peaches, plums, nectarines and grapes. Some commodities were raised by the company itself while others were bought from farmers on a cash basis. Still other produce was packed and shipped by the company on a commission basis. For the purposes of its business United Packing Co. operated ranches and packing houses, and manufactured and stocked packing materials. Its main office was located in Fresno, but its operations covered a large area in the San Joaquin Valley extending

northward 138 miles to Lodi and southward 127 miles to Arvin. At the close of 1942 the gross proceeds and net income earned by United Packing Co. amounted to \$1,468,119.64 and \$141,790.95, respectively" (R. 251).

"During the years up to 1942 Petitioners' two children were occupied primarily in obtaining an education, though each performed some services in their father's business. Harkness, Jr., attended schools until June, 1941, when he graduated from college with a major in commerce. From 1934 until 1941 he worked in his father's business during summer vacations and in 1937 he quit school for six months to help his father launch the sole proprietorship. From June, 1941, until January, 1942, he devoted his full time as an employee of United Packing Co. working as a 'regular field man' at a salary of \$150 per month plus a five per cent bonus of approximately \$910. During this six months' period he also earned four to five thousand dollars in independent deals in the fruit and vegetable business. On January 12, 1942, he entered the United States Air Corps as a private. At the close of 1942 Petitioners' son still had a credit on the books of the sole proprietorship of \$1,412.05 for prior services performed. He owned no substantial property outside of these earnings at that time" (R. 251-252).

"Harriet Harkness finished her schooling in June, 1942, when she graduated from college. During summer vacations she had occasionally performed secretarial services in her father's business. Harriet worked full time as a secretary at United Packing Co.

from June until August, 1942, at which time she married William H. Colgate, Jr., who was then serving in the United States Army. Following her marriage she spent her time housekeeping for her husband at various military posts in the United States until October, 1944. She owned no significant amount of property at the time of her marriage.

“Harriet’s husband, William Colgate, had resided in Fresno County, California, all his youth and had been an acquaintance of the Harkness family for a number of years prior to his marriage in 1942. He attended college, majoring in commerce, and during summer vacations was employed by the Peerless Pump Company, the largest supplier of irrigation pumps in the San Joaquin Valley. Colgate later quit school and worked full time for this company for nine months before enlisting in the United States Army in March, 1941. This was in keeping with his desire to devote his career to agricultural pursuits in the Valley. As an assistant foreman aiding in the installation of extensive irrigation systems, Colgate acquired considerable knowledge of the mechanics of irrigation. After his marriage to Harriet, they were stationed at Columbus, Ohio, during the latter part of 1942 and throughout 1943” (R. 252-253).

“In the fall of 1942 Harkness, Sr., became convinced that it would be advantageous to convert the operation of his fruit packing and shipping business from a sole proprietorship to a partnership composed of his wife, himself and his two children in the coming year. Many reasons dictated that decision. Pri-



marily he desired to obtain the services of his son and son-in-law in the business. He felt that as a result of their college education and the practical experience they had gained pursuing agricultural employment in the Valley that they would make skilled, competent supervisors capable of overseeing the widespread operations of the company. Secondly, from his experience in the fruit and vegetable packing industry, Harkness believed that it was essential to increase the capital investment in the company by allowing annual profits to remain in the business. This was necessary not only to permit payment of extensive operating expenses, to allow for expansion of the company facilities and equipment and to develop new business, but also to meet the exigencies of bad crop years when the company's income declined drastically. Furthermore, in 1942 fruit packers were anticipating a decline in profits due to labor shortages, low transportation priorities for their produce, and the probability that prices would tumble as in World War I. These circumstances only increased the need for increasing the capital reserve of United Packing Co. Yet it had been Harkness' experience in past years that to hold qualified supervisory personnel it was necessary to pay them large bonuses or percentages of profits which they invariably withdrew from the business and often used to set themselves up in competition with him, thus draining the company's capital. He felt the only way to retain profits in the company was to bring into the business persons who felt as he did. Through long discussions with Harkness, Jr., and William Colgate, Petitioner knew that they agreed with him that only



a reasonable amount of the profits should be withdrawn from United Packing Co. and the rest of the net income should be allowed to accumulate in the business" (R. 253-255).

"While Harkness, Sr., was well aware that neither Floyd, Jr., nor William Colgate would be available to serve United Packing Co. for the duration of the war and he would be the only active partner in the meantime, yet he desired them to acquire an interest in the company at this time to guarantee their future help in running the business after their release from the Army.

"Furthermore, formation of the partnership accorded with the wish of Harkness, Sr., to give his children an opportunity to make good. Even when Floyd, Jr., was a boy he and his father planned for the day when the former would be a full-fledged partner. After graduation from college in 1941 Harkness, Jr., had pressed his father to give him the status of a partner in the business, and while Harkness, Sr., had too many financial commitments to do so in that year, yet he promised his son he would make provision for him to purchase an interest in the business. Now Petitioner desired to fulfill that promise. It was long understood that if one child was given an opportunity to participate in the business, the other would be given an equal opportunity. Offering Harriet an opportunity to become a partner in his business not only fulfilled this pledge, but was a long step toward securing the eventual services of her husband which Petitioner so greatly desired" (R. 253-255).

“While Harkness, Sr., consulted a lawyer concerning the feasibility of converting his business into a partnership and was thus aware of the tax-saving possibilities inherent therein, yet this fact was only a secondary consideration with him, and he would have entered into this arrangement regardless thereof.

“During the fall of 1942 Harkness, Sr., held lengthy conversations with his son, who was stationed at a nearby airfield, regarding the proposed partnership. Harkness, Jr., eagerly accepted the chance to buy an interest in United Packing Co. for this had been his great desire for many years and assured him of full participation in the business on his return from the service. Petitioners and young Harkness then definitely planned to convert the business into a partnership starting in 1943.

“Over the same period of time Harkness, Sr., also corresponded with his daughter and offered her either the opportunity to invest in United Packing Co. or some other enterprise. Furthermore, it was understood that if she decided to come into her father's business, her husband, William Colgate, would be allowed to participate in the partnership following his release from the Army. Harriet and William Colgate debated at length whether it was advisable for her to buy an interest in her father's business or invest elsewhere. Finally Harriet exercised her option to procure an interest in United Packing Co. after her husband determined he wanted to be associated with United Packing Co. upon his return from the service.

“Thus, by November, 1942, Petitioners and both their children generally agreed to the formation of a partnership for the operation of United Packing Co. in the coming year, though the details of the partnership relationship had not been worked out. A ‘Certificate of Co-Partnership Transacting Business under Fictitious Name’ was executed on November 12, 1942, which Petitioners and young Harkness signed on that date and Harriet signed on November 28. It stated that the four were co-partners carrying on business under the name of United Packing Co. and that Harkness, Sr., was the general manager in full charge of all business operations. This certificate was published in a local paper and later filed with the county recorder of Fresno County.

“On December 31, 1942, ‘Articles of Partnership,’ providing the detailed terms of the proposed partnership, were drafted and met the approval of all but Harriet Colgate, who refused to sign until provisions as to the control of the business and as to purchase of a deceased partner’s share were modified” (R. 255-257).

“On January 1, 1943, Petitioners transferred to United Packing Co., a partnership, most of the assets and some of the liabilities of United Packing Co., sole proprietorship, existing on December 31, 1942, resulting in a net worth of \$138,241.61 for the partnership on that date. Harkness, Jr., and Harriet Colgate each bought a one-fourth interest in the partnership for \$34,560.41, equivalent to one-fourth of its net worth. To pay Harkness, Sr., for his share in the



partnership, the son used \$1,392.05 of the credit he had earned as compensation for prior services rendered the sole proprietorship and on January 2, 1943, signed a promissory note for the remaining \$33,168.35 with interest at four per cent per annum. Harriet Colgate purchased her partnership interest from her father with a promissory note dated January 2, 1943, for \$34,560.40 plus four per cent interest per annum. William Colgate joined her on the note as co-maker \* \* \*<sup>1</sup> (R. 257-258).

"These transactions were reflected on the books of United Packing Co., copartnership, as of January 1, 1943. It showed assets of \$142,861.03 and liabilities of \$4,619.92 and a net worth of \$138,241.61. Capital of the partnership was stated to be \$138,241.61 resulting from contributions of \$34,560.41 each from the three Harknesses and Harriet Colgate.

"On January 4, 1943, pending acceptance by Harriet Colgate of the articles of partnership drafted on December 31, 1942, Harkness, Sr., Molly Harkness, Harkness, Jr., and Harriet Colgate signed a supplemental agreement fixing compensation and distribution of partnership profits among the partners. The salary of Harkness, Sr., as general manager of the partnership, was fixed at 75 per cent of the first \$100,000 of the partnership net income. There was no provision for salaries for the other partners. The re-

---

<sup>1</sup>"No collateral was required on either note". This finding ignores that under the terms of the partnership agreement the children pledged the first profits derived from the business to the payment of the notes, and also that the notes were secured by their respective interests in the partnership (R. 263, 119, 121).



mainder of the first \$100,000 of partnership net income was to be divided equally among the partners, as were any profits over that amount. Paragraph three of this supplemental agreement stated:

‘It is understood and agreed that the payment of the 75% of the net income as provided for, is being made to first party on account of the fact that he is the only active co-partner in said business at this particular time and will continue as such during the duration of the present war.’

“During January, 1943, Harkness, Sr., discussed with the Colgates the modifications sought by Harriet Colgate in the partnership agreement drafted on December 31, 1942. Harriet withdrew her objections when the original draft was altered to meet her demands. The reformed partnership agreement was signed by the three Harknesses on February 27, 1943, and by Harriet Colgate on March 10, 1943”<sup>2</sup> (R. 258-259).

“In February, 1943, an undivided one-half interest in a 300-acre vineyard and orchard was acquired by Harkness, Sr., Molly Harkness, Harkness, Jr. and Harriet Colgate as tenants in common. The other half interest in the ranch was acquired by Chris Sorenson and his wife. Sorenson was a supervisory employee of United Packing Co. All funds for purchase of the vineyard were supplied by United Packing Co. and the amount loaned to Sorenson was repaid to the com-

---

<sup>2</sup>At this point, the Tax Court quotes in full the partnership agreement. This instrument is set forth in the Appendix to this brief.

pany by him. The fifty per cent interest acquired by the Harknesses and Harriet Colgate was included as an asset of United Packing Co. and subsequent income therefrom was included in its net income. Previously on January 16, 1943, by a bill of sale the personal property on the River Ranch had been conveyed to Chris A. Sorenson and Katherine Sorenson, his wife, and 'Floyd J. Harkness, Molly A. Harkness, Harriet Harkness Colgate, and Floyd J. Harkness, Jr., co-partners, doing business under the firm name and style of United Packing Co., a co-partnership.' Prior to these purchases, all the partners were consulted with respect to them, and Harkness, Jr., who was familiar with the land, approved the transactions" (R. 269-270).

"\* \* \*.<sup>3</sup> Harriet and William Colgate were absent from Fresno until his discharge from the armed services in October, 1944, so consequently she performed no services for United Packing Co. during the year 1943 nor did she participate in the management of its affairs. Throughout the year 1943 until December, Harkness, Jr., was stationed at Hamilton Field, California, approximately six hours traveling time from Fresno, and frequently visited the company's office and packing plants on weekends. While he was unable to participate in the business activities, yet he discussed its problems with his father on these occasions. In December, 1943, Harkness, Jr., went over-

---

"During the year 1943 there was no change in the operations of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr.'" This clearly erroneous finding is contradicted by the findings that precede and follow it.

seas with the Air Corps and did not return to Fresno until January, 1946.

“In 1943 United Packing Co. earned gross proceeds of \$2,572,905.53 and a net income of \$361,582. In accordance with the terms of the supplemental agreement Harkness, Sr., was paid a salary of \$75,000 and Harkness Sr., Molly Harkness, Harkness, Jr., and Harriet Colgate each were credited with \$71,645.50 as their respective shares of the profits.

“Harriet’s credit on the partnership books was first applied to pay off the principal and interest on her promissory note to Harkness, Sr., in the amount of \$35,942.82, and to offset prior withdrawals from her capital account consisting of cash in the amount of \$112.97 and sums of \$1,070.89 and \$31,423.67 paid to the collector of internal revenue. The balance of \$3,095.15 which she left in the business at the close of 1943 was withdrawn in 1944 to pay for taxes and personal expenditures. Of the \$71,645.50 credited to Harkness, Jr., \$34,495.08 was turned over to his father to pay the principal and interest on his promissory note. Of the remaining \$37,150.42 which he left in the business in 1943, young Harkness expended \$331.58 for his own use in 1944” (R. 270-271).

“United Packing Co. filed a partnership return for the year 1943, reporting a net income of \$361,582, compensation of \$75,000 paid to Harkness, Sr., and the distribution of \$71,645.59 from profits to each of the three Harknesses and to Harriet Colgate.

“Harkness, Sr., and Molly Harkness filed separate income tax returns in 1943. As residents of a com-



munity property state each reported one-half of the total income of \$218,291 they together received from United Packing Co. in 1943, or \$109,145.50.

“In his notices of deficiency sent to Petitioners Respondent determined that the net income of United Packing Co. for 1943 was \$361,823 and that each Petitioner realized one-half of this amount, or \$180,916, as community property income. The notice of deficiency sent to Harkness, Sr. stated in part:

(a) On December 31, 1942, you and your wife Molly A. Harkness, together with your two children, Floyd James Harkness, Jr., and Harriet Harkness Colgate, executed an instrument purporting to create a family partnership. Since Floyd James Harkness, Jr., and Harriet Harkness Colgate contributed no capital originating with themselves, rendered no services to the business, and were not required to participate in the control and management of the business under the terms of the alleged partnership agreement, it is held that they did not acquire valid partnership interests in the United Packing Company. Accordingly, profits from the above-named organization are re-allocated to you and your wife on a community property basis, thus increasing your taxable income by \$71,770.50 as shown below.

Total net profit of United Packing Co.	\$361,832.00
Your community one-half share	180,916.00
Amount reported on return	109,145.50
	<hr/>
Adjustment—Increase	\$ 71,770.50



Similar language was contained in the notice of deficiency received by Molly Harkness.

“\* \* \*”<sup>4</sup> (R. 271-273).

The findings of fact of the Tax Court end with the above quotation from the notice of deficiency transmitted by the Respondent to the Petitioners and with the ultimate finding quoted in the footnote below. It should be noted at this point that neither the Tax Court nor the Respondent found that the Petitioners' children were not the true owners of the capital that they contributed to the partnership. The ownership by Petitioners' children of this capital is conceded by the Tax Court and the Respondent, but the validity of the partnership for tax purposes is disputed solely because, as the Respondent stated in his notices of deficiency, the children “contributed no capital originating within themselves”<sup>5</sup> (R. 272).

It should likewise be noted that the Tax Court, in making its findings, limited itself to a consideration of the evidence relating to the years which preceded the formation of the partnership and to the

---

<sup>4</sup>“The three Harknesses and Harriet Colgate had no intent to join together in conducting the business of United Packing Co. as bona fide partners in 1943 and thus their partnership was not valid for tax purposes that year.” This ultimate finding is contrary to the findings that precede it and is contrary to the evidence in the record not considered by the Tax Court.

<sup>5</sup>“This indicates a basic and erroneous assumption that one can never make a gift to a member of one's family without retaining the essentials of ownership if the gift is then invested in a family partnership.” *Commissioner v. Culbertson*, 337 U. S. 732, 747, fn. 18, 93 L. Ed. 1659, 1668 (1948). The instant case is stronger than the one envisaged by the Supreme Court. Here we are dealing with an unimpeachable sale—not a gift.

first year in which the partnership operated. A substantial portion of the evidence in the record relates to the performance by the parties of the partnership agreement from 1944 to 1948. All of this evidence was admitted without objection on the part of counsel for Respondent, yet the Tax Court made no findings thereon. This evidence discloses that Petitioners and their children intended to and did join together in conducting the business of United Packing Co. as bona fide partners in 1943 and in all subsequent years.

**(b) The Facts Which the Tax Court Did Not Consider.**

In the fall of 1944, Harriet Colgate and her husband returned to Fresno, and Colgate immediately went to work for the partnership. He worked under the supervision of Sorenson a very short while (R. 129, 153, 217-218). Thereafter, when Sorenson left the employ of the partnership, on January 15, 1945, William Colgate became the fifth partner in the enterprise. This is evidenced by a supplemental agreement dated January 16, 1945 (R. 37-40, Ex. 2-B). As of that date, Colgate and his wife each became the owners of an undivided one-eighth interest in the partnership. This supplement provided that Colgate would be employed as a field man, receiving for his services the usual field man's salary, and further provided that this arrangement with Colgate was to continue in full force and effect until the return of Harkness, Jr. Ever since the fall of 1944, Colgate has continuously rendered services to the partnership, and since January of 1945 has been in

charge of the operations of the partnership in the Sanger-Clovis area (R. 129, 217-222).

In January of 1946, Harkness, Jr., was discharged from the Army and returned to Fresno, and forthwith began to render services to the partnership (R. 128, 229, 240-241). On January 11, 1946, the partners executed a further supplemental agreement. This supplement provided that Colgate should receive as compensation 25% of the net profits derived from operations in the Clovis-Sanger districts and 25% of the net profits derived from any other deals actively supervised by him. Under the terms of the supplement, Harkness, Jr., was appointed assistant manager of all operations and his compensation was fixed at 25% of the net proceeds of the partnership. The supplement also reaffirmed the provision fixing the compensation of Harkness, Sr., at 75% of the first \$100,000 of partnership net income, which, as set forth in the supplement of January, 1943, was to be in effect only for the duration of the war (R. 75-77, Ex. 8-H). Harkness, Jr., has ever since January of 1946 continuously rendered services to the copartnership as assistant manager (R. 230, 240-243).

The foregoing facts show that Petitioners' son and son-in-law performed their commitments to render services to the partnership when it became possible to do so. The facts that follow show that the parties complied with their agreement to increase the capital of the partnership and that Petitioners' children had full and untrammelled control of their share of the partnership income.



Exhibit "6-F" attached to the stipulation of facts (R. 55-68) accurately reflects the condition of the books of account of the partnership in so far as the capital accounts of the five partnerships are concerned. This exhibit shows that, whereas the partnership had a net worth of \$138,241.61 at its inception, it had, as of December 31, 1947, a capital of approximately \$260,000.00. This Exhibit discloses that, as of December, 1944, from accumulated and undistributed profits earned in 1943, including profits from the "River Ranch", the partners made the following contributions to increase the capital of the partnership: Floyd Harkness, Sr., and Molly A. Harkness, \$60,-879.19; Floyd J. Harkness, Jr., \$30,439.60; Harriet and William H. Colgate, \$30,439.60.

Exhibit "6-F" also shows that as of December 31, 1947, Petitioners had as capital, undistributed profits, and salaries payable to them of \$385,367.58, as compared to \$105,688.12 for Harkness, Jr., and \$121,-650.11 for Harriet Colgate and her husband.

Exhibit "6-F" also clearly shows that there has been a proportionate distribution of earnings to the members of the partnership. This Exhibit speaks for itself, but for the convenience of the Court and for the further purpose of demonstrating that not only have such distributions been made on paper, but have in fact been made, we are submitting for the Court's consideration summaries of analyses of the capital accounts of Floyd J. Harkness, Jr., and Harriet and William H. Colgate for the period 1943-1947.



SUMMARY OF ANALYSIS OF DISPOSITION OF INCOME  
OF FLOYD J. HARKNESS, JR.

GROSS INCOME:

Salary (1946-1947)	\$111,619.88
Profits (1943-1947)	220,120.15
Other credits to account	8,040.05
	<hr/>
Total gross income	\$339,780.08

DISPOSITION OF GROSS INCOME

Taxes:

Collector of Internal Revenue (1943-1947)	\$106,515.98
State income taxes (1943-1947)	7,568.84
	<hr/>
Total taxes	\$114,084.82
	<hr/>
Gross income after taxes	\$225,695.26

DISPOSITION OF GROSS INCOME AFTER TAXES:

Payments on Note and Contributions to Capital:

Payment of principal and interest to petitioners December 31, 1943	\$ 34,495.08
Additional contribution to partnership capital, December 31, 1944	30,439.60
	<hr/>
Total payments	\$ 64,934.68
	<hr/>
Balance of gross income	\$160,760.58

DISPOSITION OF GROSS INCOME AFTER PAYMENT OF NOTE AND CONTRIBUTION TO CAPITAL:

Salary and Miscellaneous Withdrawals:

Salary withdrawals (1946-1947)	\$111,619.88
Miscellaneous withdrawals (1943-47)	9,864.63
	<hr/>
Total withdrawals	\$121,484.51
	<hr/>
Balance in account on January 1, 1943	39,276.07
	1,412.05
	<hr/>
Balance December 31, 1947	\$40,688.12

SUMMARY OF ANALYSIS OF DISPOSITION OF INCOME OF WILLIAM  
H. COLGATE AND HARRIET HARKNESS COLGATE (1943-1947)

GROSS INCOME:

Salary (1944-1947)	\$ 88,408.24
Profits (1943-1947)	220,120.15
Other credits to account	3,994.00
	<hr/>
Total gross income	\$312,422.39

DISPOSITION OF GROSS INCOME

Taxes:

Collector of Internal Revenue (1943-1947)	\$ 84,954.08
State income taxes (1943-1947)	4,297.30
	<hr/>
Total taxes	\$89,251.38
	<hr/>
Gross income after taxes	\$223,171.01

DISPOSITION OF GROSS INCOME AFTER

TAXES:

Payments on Note and Contributions to  
Capital:

Payment of principal and interest to petitioners, December 31, 1943	\$ 35,942.82
Additional contribution to partnership capital, December 31, 1944	30,439.60
	<hr/>
Total payments	\$66,382.42
	<hr/>
Balance on gross income	\$156,788.59

DISPOSITION OF BALANCE OF GROSS INCOME:

Salary and Miscellaneous Withdrawals:

Salary withdrawals (1944-1947)	\$88,308.24
Miscellaneous withdrawals (1944-1947)	11,830.24
	<hr/>
Total withdrawals	\$100,138.48
	<hr/>
Balance December 31, 1947	\$ 56,650.11

The Court will observe that, in the case of Harkness, Jr., after his return from Army service, he actually

withdrew \$121,484.51 from a gross income, after taxes, of \$225,695.26.

In the case of Harriet Colgate and her husband, this summary discloses that, during the period 1944-1947, they actually withdrew \$100,138.48 from a gross income, after taxes, of \$223,171.01.

These withdrawals, expressed in percentages, show that Harkness, Jr. withdrew 56.5% of gross income, after taxes, and that Harriet Colgate and her husband withdrew 47.6% of gross income after taxes.

---

#### **SPECIFICATIONS OF ERROR.**

1. The following ultimate finding of the Tax Court is contrary to its evidentiary findings:

“The three Harknesses and Harriet Colgate had no intent to join together in conducting the business of United Packing Co. as bona fide partners in 1943, and thus their partnership was not valid for tax purposes in that year.”

2. The ultimate finding set forth in 1. above is based upon a misapplication of the law.

3. The ultimate finding set forth in 1. above is clearly erroneous because it is against the clear weight of the evidence and is arrived at by accepting part of the evidence and totally disregarding other convincing evidence.

4. The following finding of fact is clearly erroneous because it is against the clear weight of evidence and is arrived at by accepting part of the evidence and totally disregarding other convincing evidence:

“During the year 1943 there was no change in the operation of the United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr.”

5. The following ultimate finding of the Tax Court is contrary to its evidentiary findings:

“No collateral was required on either note.”

6. The ultimate finding set forth in 5. above is clearly erroneous because it is against the clear weight of the evidence.

7. The Tax Court erred in not finding, as the record shows, that Floyd J. Harkness, Jr., upon his return from the Army in January, 1946, was appointed Assistant General Manager of the partnership business, and has ever since that time, and up to January 11, 1949, the date of the hearing of this case, rendered substantial managerial services to the business.

8. The Tax Court erred in not finding, as the record shows, that during the year 1946 Floyd J. Harkness, Jr., received the sum of \$57,984.85, and during the year 1947 the sum of \$53,635.13, as salary for each of said years for services rendered as such Assistant General Manager.

9. The Tax Court erred in not finding, as the record shows, that during the period 1946 to 1947 Floyd J. Harkness, Jr., withdrew from the partnership business a total sum of \$121,484.51.

10. The Tax Court erred in not finding, as the record shows, that William Colgate was discharged from the Army in the Fall of 1944, and immediately went to



work for the partnership, and in not finding that in January, 1945, William Colgate became a fifth partner in the enterprise.

11. The Tax Court erred in not finding, as the record shows, that William Colgate has ever since January, 1945, been the Manager of the Clovis-Sanger District of the partnership and has rendered substantial services of a supervisory and managerial nature to the partnership, and in not finding that he has received the following compensation for his services: 1944, \$450.00; 1945, \$5,275.00; 1946, \$46,554.79; 1947, \$35,928.45.

12. The Tax Court erred in not finding, as the record shows, that during the period 1944 to 1947 William Colgate and Harriet Colgate have withdrawn \$100,138.48 from the partnership.

13. The Tax Court erred in not finding, as the record shows, as a whole, that Floyd J. Harkness, Jr., and Harriet Colgate were and have been ever since January 1, 1943, the true owners of an undivided interest in the assets of the partnership.

14. The Tax Court erred in not finding, as the record shows, as a whole, that Floyd J. Harkness, Jr., and William Colgate made, as of the date of the formation of the partnership, a commitment to render services to the partnership as soon as circumstances permitted.

15. The Tax Court erred in not finding, as the record shows, that Petitioners and Harriet Colgate and Floyd J. Harkness, Jr., intended to join together

in conducting the business of United Packing Co. as bona fide partners in 1943 and that their partnership was valid for tax purposes for that year.

16. The Tax Court erred in that its decision herein is contrary to the applicable decisions of the Supreme Court of the United States. (*Commissioner of Internal Revenue v. Culbertson*, 337 U.S. 733, 93 L.Ed. 1659 (1949); *Commissioner of Internal Revenue v. Tower*, 327 U.S. 280, 90 L.Ed. 670 (1946)).

17. The Tax Court erred herein in that its decision is contrary to the applicable decisions of the Tax Court heretofore made. (Issac Blumberg, 11 T.C. 663 (1948)).

18. The Tax Court erred in finding, contrary to the record, deficiencies for the year 1943, in lieu of a finding that there is no income tax due from Petitioners for said year.

---

#### SUMMARY OF ARGUMENT.

I. This court is fully empowered to review and reverse the Tax Court's decision that the Petitioners and their children did not intend to join together for the purpose of carrying on the business and sharing the profits and losses, in the same manner and to the same extent as a decision of the District Court. Under rule 52 (a), Federal Rules of Civil Procedure as interpreted by the courts, findings of fact by the Trial Court are clearly erroneous if not supported by substantial evidence, and this Court is free to draw its own inference and conclusions from the findings of

fact and the evidence. The Tax Court has disregarded material and uncontradicted evidence and has failed to give effect to many of its own findings of fact. Instead it has made inferences and conclusions unsupported by the evidence and in some instances, inconsistent with its own findings of fact.

II. The Tax Court erred in that its decision is contrary to the applicable decisions of the Supreme Court of the United States.

A. The Tax Court determined that no valid partnership within the meaning of the tax laws existed because Petitioners' children did not contribute original capital or vital services. In this the Tax Court erred because under the teaching of *Commissioner v. Culbertson* (337 U.S. 733, 93 L. ed. 1659 (1949)), the issue is not whether the members of a family partnership contributed original capital, or vital services, but whether the partners really and truly intended to join together for the purpose of carrying on the business, and sharing the profits and losses.

B. The evidence in this case shows that Petitioners' children were the true owners of the capital contributed by them to the partnership, and under the rule of the *Culbertson* case the bona fide intent to join together in a partnership is determined by ascertaining whether the alleged partners contributed services *or capital of which they were the true owners*. The Tax Court did not consider the evidence showing that Petitioners' children were the true owners of the capital contributed by them to the partnership and in this the Tax Court erred.



C. The Tax Court did not give any consideration to the evidence showing the good faith of the parties, and placed its own values on the consideration given by Petitioners' children for their respective shares in the partnership. In this the Tax Court erred. The applicable decisions show that the predominant factor to be considered is the good faith and legitimate purpose of the parties in forming the partnership. The applicable decisions also require, when the evidence discloses that there is room for an honest difference of opinion that the Tax Court refrain from placing its own values on the consideration given for an interest in a partnership. In this case the evidence shows that Petitioners, received ample consideration for the property sold to their children.

III. The Tax Court erred in making findings that are contrary to the record and in failing to consider and make findings on evidence showing the conduct of the parties in years subsequent to the tax year in question.

A. The record contains evidence of events that occurred in the years subsequent to the tax year in question. This evidence was relevant on the issue of good faith. The Tax Court did not consider this evidence in making its findings, and under the applicable decisions this was error.

B. The Tax Court erred in finding that during the year 1943 the business of the partnership was still under the control of Harkness, Sr. This is contrary to the record and fails to give effect to the intent and good faith of the parties.

C. The Tax Court erred in concluding that Petitioners' children did not have unhampered enjoyment of their respective shares of the prof-



its of the business. This conclusion is unreasonable and contrary to the record.

---

### STATUTES INVOLVED.

The applicable provisions of the Internal Revenue Code pertinent to the issue herein involved are as follows:

Sec. 11, *Internal Revenue Code* (26 U.S.C.A. §11)

#### Normal Tax on Individuals.

“There shall be levied, collected and paid for each taxable year upon the net income of every individual a normal tax determined by computing a tentative normal tax of 3 per centum of the amount of the net income in excess of the credits against net income provided in section 25, and by reducing such tentative normal tax as provided in Section 12 (c) . . .”

Sec. 22 (a), *Internal Revenue Code* (26 U.S.C.A. §22(a))

#### Gross Income—General Definition.

“(a) General Definition. — ‘Gross Income’ includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or

use of or interest in such property; also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever . . .”

Sec. 181, *Internal Revenue Code* (26 U.S.C.A. §181)

**Partnership Not Taxable.**

“Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.”

Sec. 182 (c), *Internal Revenue Code* (26 U.S.C.A. §182(c))

**Tax of Partners.**

“In computing the net income of each partner, he shall include, whether or not distribution is made to him . . .

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).”

---

**ARGUMENT.**

**I.**

ISSUES AS TO THE REALITY OF A PARTNERSHIP WITHIN THE MEANING OF THE FEDERAL REVENUE LAWS ARE FULLY REVIEWABLE BY THIS COURT.

The reality of a partnership within the meaning of the applicable sections of the Internal Revenue Code is dependent upon whether the facts disclosed

by the record show that the parties involved really and truly *intended* to join together for the purpose of carrying on a business, and sharing in the profits and losses or both.

*Commissioner v. Tower*, 327 U.S. 280, 287, 90 L.Ed. 670, 675 (1946);

*Lusthaus v. Commissioner*, 327 U.S. 293, 90 L. Ed. 679 (1946);

*Blumberg v. Commissioner*, 11 T.C. 663, 668-669 (1948);

*Hirsch v. Commissioner*, 7 T.C.M., 932, 937 (1948).

The issues as to the reality of the partnership herein involved were submitted to the Tax Court on a record which discloses no conflict in the evidence. All the evidence, oral and documentary was presented by the Petitioners. The Respondent offered no evidence to contradict the showing made by the Petitioners. We, therefore, upon submitting the case to the Tax Court argued that the rebuttable presumption in favor of the Respondents' deficiency assessment had been entirely dispelled and that the Tax Court should find that the Petitioners and their children really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses. In making our argument to the Tax Court we said:

"There are involved in this case, as stated heretofore, Sections 22(a), 181, 182, 183 and 3797 of the Internal Revenue Code and the Regulations applicable thereto issued by the Commissioner. These statutes and the Commissioner's



Regulations do not, by their express terms or by the necessary implication therefrom, raise a presumption of liability or bad faith whenever a family transaction is involved. In addition, it should be borne in mind that substance and not form controls in applying income tax statutes, and that the realities of economics and human behavior, rather than the minutiae of detail which a lawyer inserted or omitted from a partnership agreement, should determine whether a partnership is a sham or a device. (*Doll v. Commissioner of Internal Revenue*, 149 Fed. (2d) 239.) In this connection, we also respectfully point out that there is nothing in the express language of the statutes involved or in the judicial decisions interpreting them which requires the Commissioner to disregard or stigmatize as a sham that most natural of parental impulses—to give the children a better start in life by bringing them into the business.

In the light of the foregoing we contend that the Commissioner cannot, as he has, attempt to make his case solely on the fact that the partnership here in question is cast in the form of an intra-family transaction, but should have established by relevant and material evidence that in substance and in fact it was a sham and a device to escape the payment of income taxes. At this point it appears proper to ask this Court to judicially notice, as it has in the past, that bringing the sons and daughters into the family business and making provision for them is one of the ordinary and natural transactions of life. (*Isaac Blumberg v. Commissioner*, 11 T.C. —No. 80; *Fischer v. Commissioner*, 5 T.C. 506 at 516.) ‘In the ordinary transactions of life,’ says a noted



writer on the law of evidence, 'fairness and honesty are presumed, and conveyances, sales and contracts generally are presumed to have been made in good faith until the contrary appears.' (*Jones, Commentaries on Evidence*, Vol. 1, Sec. 13, pp. 99-100.)

The Commissioner did not introduce or offer any evidence to controvert the case made by the Petitioners, and there are no presumptions on which he can rely to make up for his entire lack of proof. At the outset the Commissioner had in his favor the presumption that his assessment was *prima facie* correct. This presumption of convenience means no more 'than that, in absence of evidence to the contrary, his action will be upheld, but once there is . . . contrary evidence, this presumption vanishes and the case is wide open.' (*Mertens, Law of Federal Income Taxation*, Vol. 9, Sec. 50.71, pp. 296, 297.) This presumption is a so-called 'true' presumption, or a presumption of convenience, and is not regarded as evidence. It is merely a convenient device to shift to the petitioners the burden of *going forward with*, as distinguished from the *actual burden of*, proof. In the instant case, this 'true' presumption ceased to exist when the Petitioners carried the burden of going forward with the proof. Under elementary principles, therefore, we respectfully request this Court to find that the transactions disclosed by the evidence were honest, fair and regular, and that they show an intent on the part of the Petitioners really and truly to form a partnership with their children. (*Mertens*, op. cit. Vol. 9, Sec. 50.71, p. 297; *Cyclopedia of Federal Procedure*, (2d Ed.), Vol. 7, Sec. 3169, p. 191 et seq.; *United States v. Rindskopf*,

105 U.S. 418, 26 L.Ed. 1131.) In making the foregoing statement we are cognizant of the fact that in transactions involving a family or economic unit 'a special scrutiny is necessary.' *Helvering v. Clifford*, 309 U.S. 331, 84 L.Ed. 788; *Doll v. Commissioner*, *supra*.) We are likewise aware that the Court is not compelled to accept blindly the uncontroverted evidence if it is contrary to common experience. We submit, however, that this last mentioned principle, even if applied with the utmost strictness to the evidence in the instant case, will furnish no basis for the contention of the Commissioner. We say this because we have here a case where the intentions of the parties are well evidenced by the clear terms of the contract entered into, and the acts of the parties prior, and subsequent thereto in carrying out its terms. There is nothing in this uncontradicted evidence which can be said to be contrary to common experience."

We assume that our argument and the record convinced the Tax Court because it accepted the evidence proffered by the Petitioners and made findings thereon showing that Petitioners' children were the owners of the property contributed to the partnership, that the partnership was entered into for good and sufficient business reasons and that tax avoidance was not a primary consideration motivating the Petitioners in making this arrangement with the children. Nevertheless, the Tax Court held the partnership not valid for tax purposes, on the theory that the partnership contract had remained executory or had been frustrated because Petitioners' children had not

contributed during the tax year in question "original capital" and had not rendered "vital services."

This matter was submitted to the Tax Court prior to the Supreme Court's decision in *Commissioner v. Culbertson*, 337 U.S. 733, 93 L.Ed. 1659 (1949), but the Tax Court decided the case after the Supreme Court rendered its decision in that case. In *Commissioner v. Culbertson*, *supra*, the Supreme Court painstakingly reviewed *Commissioner v. Tower*, and *Lusthaus v. Commissioner*, *supra*, and other cases bearing on the subject, and after making this review, advised the Tax Court that it could not make findings in cases involving family partnerships by merely applying the objective tests of "original capital" and "vital services." The Supreme Court told the Tax Court that it must make an inquiry into the subjective, and determine the true intent of the parties, and that in determining the true intent it should consider all the facts—"the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent . . ." (*Commissioner v. Culbertson*, *supra*, 337 U.S. 742.)

That the Tax Court did not decide this case in accordance with the admonitions of the Supreme Court is clear from a mere reading of the Tax Court's opinion. It is equally clear that it drew erroneous inferences from the uncontradicted evidence and that it



made ultimate findings contrary to its evidentiary findings and other evidence in the record not considered by it.

In reviewing the Tax Court's findings as to the reality of the partnership, this Court is fully authorized to consider all the evidentiary facts and circumstances, and to reverse the Tax Court where they do not support or are inconsistent with the ultimate findings.

Limitations upon the scope of review of such issues by the Courts of Appeals, imposed by a series of Supreme Court decisions culminating in *Dobson v. Commissioner*, 321 U. S. 231, 88 L.Ed. 691 (1944), have been removed by 1948 legislation. Section 1141 (a), Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948 (Public Law 773, 80th Cong., 2nd Sess.), 62 Stat. 646, provides that the Courts of Appeals have jurisdiction to review the decisions of the Tax Court "in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury." This reads into the Internal Revenue Code the provisions of Section 52 (a) of the Federal Rules of Civil Procedure.

*Grace Bros. v. Commissioner*, 173 F. (2d) 170 (C.A. 9, 1949);

*Estate of Sullivan v. Commissioner*, 175 F. (2d) 657 (C.A. 9, 1949).

In the application of rule 52 (a), two basic principles are established by numerous decisions:

1. This Court may review both the facts as found by the trial Court and the evidence upon which those



facts are based. If the findings of fact are not supported by substantial evidence they are clearly erroneous within the meaning of rule 52 (a), and this Court is not bound by those findings.

2. This Court is never bound by the inferences and conclusions drawn by the trial Court from its findings of fact, but is always free to draw its own inferences and conclusions from the findings and the evidence.

These two basic principles are accepted and applied by this Court in *Estate of Gillette v. Commissioner*, 182 F. (2d) 1010, 1013-1014 (C.A. 9, 1950).

In the present case the evidentiary facts are not in conflict or dispute. This Court is not asked to determine the credibility of witnesses or to resolve a conflict in the evidence. The issue before this Court is whether petitioners and their children truly intended to enter into a partnership relationship. The resolution of this issue does not require reliance upon the Tax Court's expertness in tax matters.

In *Estate of Gillette v. Commissioner, supra*, a case not involving a technical tax question, the Court said:

“It is commonly stated, and properly so, that due respect should be given to the Tax Court's expertness in tax matters. While in most circumstances such respect would weigh heavily, we are not impressed by it here where the ultimate inference of fact must be as to what the decedent contemplated as the driving reason for his actions regarding his property. In this duty, which does not bring technical tax questions into play, it is in no way derogatory to the Tax Court to say that United States Courts of Appeals are

as well equipped to draw inferences as is the Tax Court and for that reason the Tax Court decision calls for little more weight than its logic suggests.”

There being no conflict in evidence, and there being no technical questions upon which the expert judgment of the Tax Court might be determinative, this Court has full freedom to review the issues presented, and the findings of the Tax Court.

Much of the uncontradicted evidence considered material by the petitioners was disregarded in the Tax Court’s findings and opinion, but the principal error made by the Tax Court was in failing to give effect to many of its own findings of fact. It has drawn inferences and reached conclusions that are unsupported by the evidence, and in some instances are inconsistent with its own findings of fact.

The action of the Tax Court can thus be characterized by Mr. Justice Reed’s statement in his dissenting opinion in *Lusthaus v. Commissioner of Internal Revenue*, supra, where he stated:

“The suggestions seems to be that an inference of intention entirely contrary to all the primary facts may be deduced at will and without challenge by the tax court.” (327 U. S. 302, 90 L. Ed. 687.)

This court is empowered in this case to review the evidence adduced at the hearing to draw the proper inferences or conclusions therefrom and to determine the ultimate fact that the three Harknesses and Harriet Colgate intended to join together in conducting

the business of United Packing Co. as bona fide partners in 1943 and thus their partnership is valid for tax purposes in that year.

---

## II.

THE TAX COURT ERRED IN THAT ITS DECISION IS CONTRARY TO THE APPLICABLE DECISIONS OF THE SUPREME COURT OF THE UNITED STATES.

A. The Tax Court Failed to Apply the "Reality Test" as to the Existence of a Family Partnership Set Forth in *Commissioner v. Culbertson*.

The Supreme Court, in *Culbertson v. Commissioner*, supra, established that the reality of a partnership for tax purposes should be determined on whether or not the parties truly intended to join together in conducting a business. It rejected as invalid tests which do not take into account the intent of the parties. In this connection the Supreme Court said:

"But the Tax Court did not view the question as one concerning the bona fide intent of the parties to join together as partners. Not once in its opinion is there even an oblique reference to any lack of intent on the part of respondent and his sons to combine their capital and services 'for the purpose of carrying on the business.' Instead, the court, focusing entirely upon concepts of 'vital services' and 'original capital,' simply decided that the alleged partners had not satisfied those tests when the facts were compared with those in the Tower Case. The Court's opinion is replete with such statements as '*we discern nothing constituting what we think is a requisite contribution to a real partnership*,' '*we find no son adding*



*'vital additional service' which would take the place of capital contributed because of formation of a partnership' and 'the sons made no capital contribution within the sense of the Tower Case'.*" (Emphasis Supplied). 337 U. S. 743-745, 93 L.Ed. 1666).

In this case, as in the *Culbertson* case, the Tax Court's opinion is replete with statements concerning the absence of original capital contributions and vital services, and although it is couched in "*Culbertson*" language, it reveals that the Tax Court decided the case solely by an application of the vital services—original capital test. That the Tax Court relied solely on these invalid tests is evidenced by the following excerpts from its opinion:

1. "... it was not contemplated by any of the parties that the Harkness children would contribute substantial capital or vital services to the conduct of the business in 1943 or play any active part in its management" (R. 275).

2. "The circumstances existing in the fall of 1942 also make it obvious that no vital service or contributions of original capital could have been expected from the Harkness children in 1943" (R. 276).

3. "In keeping with economic status, neither Harkness child made any substantial contribution of new capital to United Packing Co. when the partnership was formed in 1943" (R. 276).

"... , we must conclude that neither Harkness, Jr., nor Harriet Colgate contributed any substantial capital not already available to the com-



pany within the meaning of *Lusthaus v. Commissioner*, 327 U. S. 293” (R. 277).

4. “Young Harkness and Harriet Colgate rendered no vital services, nor did they participate in the management of the business during that year” (R. 278).

The Tax Court in an attempt to bring its decision within the letter of the Supreme Court’s admonition found, with respect to intent, that “it was not *contemplated by any of the parties* that the Harkness children would contribute substantial capital or vital services” (R. 275).

Having found that it was intended by the parties that the children would not contribute substantial capital, the Tax Court then concluded that the parties “had no present intent . . . to operate as a genuine partnership” (R. 280).

It seems to us obvious that the Tax Court in fact made no actual finding as to intent but declared the partnership invalid on the basis of the tests rejected by the Supreme Court.

**B. The Tax Court Erred in Not Considering, in Making Its Ultimate Finding With Reference to Intent, the Evidence Relating to the Ownership of the Capital Contributed by the Children to the Partnership.**

The Supreme Court in the *Culbertson* case, *supra*, did not remand the proceeding to the Tax Court for the purpose of having it find whether it had been intended or contemplated by the parties that the Culbertson children would contribute substantial capital

or vital services. Rather, the Supreme Court ordered the Tax Court to find whether, during the years in question, the children rendered services or contributed capital of which they were the true owners, and to determine from such findings whether the parties had the requisite intent to join together in a genuine partnership. In remanding that case the Supreme Court said:

“The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent’s sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of *contributions of capital of which they were the true owners*, as we have defined that term in the Clifford, Horst and Tower cases?” (Emphasis supplied.) (337 U. S. 748, 93 L.Ed. 1668.)

It will be noted that the Supreme Court did not require the Tax Court to find on intent on the basis of original capital, but it merely required a determination as to whether the children were the true owners of the capital contributed to the partnership.

In the instant case, the evidentiary findings of the Tax Court as to the true ownership of the capital contributed by the children are as follows:

“On January 1, 1943, petitioners transferred to United Packing Co., a partnership, most of the assets and some of the liabilities of United

Packing Co., sole proprietorship, existing on December 31, 1942, resulting in a net worth of \$138,241.61 for the partnership on that date. Harkness, Jr., and Harriet Colgate each bought a one-fourth interest in the partnership for \$34,560.41, equivalent to one-fourth of its net worth. To pay Harkness, Sr., for his share in the partnership the son used \$1,392.05 of the credit he had earned as compensation for prior services rendered the sole proprietorship and on January 2, 1943, signed a promissory note for the remaining \$33,168.35 with interest at four per cent per annum. Harriet Colgate purchased her partnership interest from her father with a promissory note dated January 2, 1943, for \$34,560.40 plus four per cent interest per annum. William Colgate joined her on the note as co-maker . . .”<sup>7</sup> (R. 257-258).

The above described transaction is formally evidenced by the following provision contained in the partnership agreement:

“ . . . first and second parties herein, do by these presents, sell, convey and set over, an undivided one-fourth partnership interest in and to all of the partnership property of the United Packing Co. to each of the third and fourth parties, namely, Floyd James Harkness, Jr., and Harriet Harkness Colgate, and from this date on each of the said co-partners above named, shall be and become the owners of an undivided one-fourth interest of all of the property of the said co-partner-

---

<sup>7</sup>The finding deleted reads: “No collateral was required on either note”. We will elsewhere show that this finding was entirely erroneous.



ship doing business under the firm name and style of United Packing Co. and that the real and personal property which shall compose the capital of the said co-partnership and belong to the newly organized co-partnership is described in a Schedule marked Exhibit "A" and attached hereto and made a part of this agreement as if herein fully set out, and that there shall also belong to said co-partnership any and all other assets which now belong to said co-partnership and are not herein described as well as any and all other assets which may hereafter belong to said co-partnership; that all thereof shall belong equally to all of the partners herein named and in consideration of said first party conveying all of said real and personal property to said co-partnership being conducted under the firm name and style of the United Packing Co., and which is agreed to be of the net value of \$138,241.61, that the said third and fourth party shall each execute in favor of first party a promissory note in the sum of \$34,560.40, payable in the manner as therein set forth to first party, and which sum shall be the purchase price for their undivided one-fourth interest in and to all of the assets of said co-partnership" (R. 261-262).

There is no statement either in the findings or in the opinion that expressly or impliedly attacks the good faith of the transaction described in the above quoted findings. The Tax Court merely disregarded this unimpeachable transaction in arriving at its decision. It must, therefore, be conceded that the Harkness children made "contributions of capital of which they were the true owners" to the partnership.



The Tax Court, contrary to the mandate of the Supreme Court, did not consider this fact in this case. The correct approach to the problem is illustrated by the Tax Court's opinion in its second decision in the *Culbertson* case. There the Tax Court said:

“Under the facts which we have found, was there a partnership within the purview of the applicable statutes and decisions? After discussion of the principles involved, the Supreme Court held that the case be remanded to us for decision as to which, if any, of the petitioner's sons ‘were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners’ as that term is defined in *Helvering v. Clifford* 309 U.S. 331; *Helvering v. Horst*, 311 U.S. 112, and *Commissioner v. Tower*, 327 U.S. 280. In so deciding, we have not placed emphasis upon any one or more questions or principles involved, but have considered all of the evidence in the light of the opinion of the Supreme Court in this cause and those opinions to which it refers.”

*Culbertson v. Commissioner*, 9 T.C.M. 647, 652 (1950).

After having correctly stated the law, the Tax Court found that the Culbertson children were not, under the facts disclosed by the record, the true owners of the capital contributed, and on the basis of

this finding, determined that the parties had not truly intended to join together in a partnership business. The record in the instant case does not permit the Tax Court to make a similar finding and for this reason the Tax Court has attempted to rob this good faith transaction of its reality by making certain erroneous findings and by failing to consider other evidence in the record.

In the portions of this brief that follow, we will discuss the erroneous findings of the Tax Court and its error in not making findings with respect to other evidence in the record which establishes the reality of the transaction.

**C. The Tax Court Erred in Not Giving Any Consideration to the Good Faith of the Parties and in Substituting Its Judgment for That of the Petitioners in Appraising the Value of the Consideration Given by the Children for Their Interest in the Partnership.**

The Supreme Court, in the *Culbertson* case, told the Tax Court to give effect to the good faith of the parties and not to attempt to substitute its judgment for that of the parties in appraising the value of the services or capital contributed to the partnership, and in so doing said:

“Unquestionably a court’s determination that the services contributed by a partner are not ‘vital’ and that he has not participated in ‘management and control of the business’ or contributed ‘original capital’ has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners. But such a determination is not conclusive, and that is the vice in the ‘tests’ adopted by the Tax Court.

It assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the partnership. If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient. The Tower Case did not purport to authorize the Tax Court to substitute its judgment for that of the parties; it simply furnished some guides to the determination of their true intent."

(337 U.S. 744-745, 93 L.Ed. 1666, 1667.)

It is clear that in this case the Tax Court did not heed the admonition of the Supreme Court contained in the above quotation.

The evidentiary findings of the Tax Court clearly showed that the petitioners were motivated in forming the partnership by legitimate reasons and not by a desire to minimize taxes. In this connection, the findings of the Tax Court show the following:

"In the fall of 1942 Harkness, Sr., became convinced that it would be advantageous to convert the operation of his fruit packing and shipping business from a sole proprietorship to a partnership composed of his wife, himself and his two children in the coming year. *Many reasons dictated that decision.* Primarily he desired to obtain the services of his son and son-in-law in the business. He felt that as a result of their college



education and the practical experience they had gained pursuing agricultural employment in the Valley that they would make skilled, competent supervisors capable of overseeing the widespread operations of the company. Secondly, from his experience in the fruit and vegetable packing industry, Harkness believed that it was essential to increase the capital investment in the company by allowing annual profits to remain in the business. This was necessary not only to permit payment of extensive operating expenses, to allow for expansion of company facilities and equipment and to develop new business, but also to meet the exigencies of bad crop years when the company's income declined drastically. Furthermore, in 1942 fruit packers were anticipating a decline in profits due to labor shortages, low transportation priorities for their produce, and the probability that prices would tumble as in World War I. These circumstances only increased the need for increasing the capital reserve of United Packing Co. Yet it had been Harkness' experience in past years that to hold qualified supervisory personnel it was necessary to pay them large bonuses or percentages of profits which they invariably withdrew from the business and often used to set themselves up in competition with him, thus draining the company's capital. He felt the only way to retain profits in the company was to bring into the business persons who felt as he did. Through long discussions with Harkness, Jr., and William Colgate petitioner knew that they agreed with him that only a reasonable amount of the profits should be withdrawn from United Packing Co. and the rest of the net income should be allowed to accumulate in the business.



While Harkness, Sr., was well aware that neither Floyd, Jr., nor William Colgate would be available to serve United Packing Co. for the duration of the war and he would be the only active partner in the meantime, yet he desired them to acquire an interest in the company at this time to guarantee their future help in running the business after their release from the Army. \* \* \*

\* \* \* *While Harkness, Sr., consulted a lawyer concerning the feasibility of converting his business into a partnership and was thus aware of the tax saving possibilities inherent therein, yet this fact was only a secondary consideration with him, and he would have entered into this arrangement regardless thereof*” (R. 253-256) (Emphasis supplied).

The Tax Court found, as the foregoing findings indicate, that the parties were in good faith and animated by a legitimate purpose when they determined to form the partnership. The Tax Court, however, did not consider this factor in making its decision. This must be held to be error. In *Greenberger v. Commissioner*, 177 F. (2d) 990, 994 (C.A. 7, 1949), the Court of Appeals said:

“The Court in the Culbertson case left no doubt that the predominant factor is the good faith and legitimate purpose of the parties in forming a partnership.”

The record and the findings also show that the Petitioners received good and valuable consideration for

the property transferred to the partnership and that the contributions made by their children and their son-in-law to the partnership were adequate. The Tax Court, however, has substituted its judgment for that of the Petitioners in appraising these values. In so doing the Tax Court has attempted to minimize the consideration given by the children by finding, contrary to the record, that the notes executed by them in payment for their interest in the partnership were not secured by collateral (R. 258).

That the action of the Tax Court in this regard is unwarranted is disclosed by the following facts in evidence:

1. The notes, unconditional promises to pay, were executed by the Petitioners' children and son-in-law. The Petitioners expected these notes to be paid regardless of whether or not income or profits were derived from the operation of the partnership (R. 190).

2. The son and the son-in-law were regarded by the Petitioners as being capable of rendering valuable services and were for this reason worthy of credit. In the judgment of the Tax Court the possession of assets rather than the ability to earn determines whether credit should be extended.

3. The notes show, on their face, that they were secured by the interests of the children in the partnership. Each note contains the following language: "This note is secured by my one-fourth interest in the United Packing Co. of Fresno, California" (R. 119; 121).

These notes were likewise secured by the income to be derived from the partnership earnings. The partnership agreement states:

“\* \* \* any profits which third and fourth parties are entitled to receive shall be paid to first party and applied by him first, to any payment which first party may have advanced to third and fourth parties, together with interest thereon, and the balance thereof, if any, shall be applied by first party in the payment of the promissory notes which the said third and fourth parties have executed in favor of first party for the purchase price of their share in said co-partnership business” (R. 263).

The Petitioners were, therefore, secured not only by the ability of their son and son-in-law to earn but also by the value of the childrens' interest in the assets and income of the partnership. We submit, therefore, that the children were given nothing but credit and that their contributions should be deemed original capital.

4. The partnership agreement states:

“\* \* \* each partner shall likewise share equally in any losses which the said partnership may sustain and that each partner shall in the event it becomes necessary to furnish additional funds by reason of any losses which the said partnership may sustain, then each partner shall furnish and pay into the said business his equal share which may be necessary in order to continue on with the said co-partnership business” (R. 269).

It is clear that that transaction and commitment evidenced by the partnership agreement was bona fide



and it must, therefore, be conceded that the Petitioners received additional valid consideration through their childrens' agreement to share the losses and to furnish additional capital when necessary. An agreement to contribute capital and assume the risks and liabilities attached to the partnership relationship is in law valid and adequate consideration. (See 47 C.J., *Partnerships*, Sec. 46, p. 654.)

5. The present commitment of the son and son-in-law to render services in the future was appraised by Petitioners as of great value to them, and we are told in the concurring opinion of Mr. Justice Burton in the *Culbertson* case that:

“A present commitment to render future services to a partnership is in itself a material consideration to be weighed with all other material considerations for the purposes of taxation as well as for other partnership purposes.” (337 U.S. 749, 93 L.Ed. 1669).

In this connection it should be observed that a present commitment to render services in the future has been held valid consideration for the transfer of property. (37 C.J.S., *Fraudulent Conveyances*, Sec. 148, p. 969.)

The evidence in the record not considered by the Tax Court shows that the commitment to render services in the future by Petitioners' son and son-in-law was fully performed (R. 129, 217-222; 128, 229-230, 240-243). It is clear, therefore, that as to this part of the agreement there was no failure of consideration and that Petitioners received what they bargained for.



The evidence also discloses that the agreement to conserve profits and to increase the capital of the partnership was likewise performed by all the parties (Exhibit "6-F," R. 55-68).

Finally, it should not be overlooked that in the view of the Tax Court in other cases, a promissory note paid out of the profits of a partnership is a valid capital contribution. In the case of *Tindall v. Commissioner*, 14 T.C., No. 125 (1950), the Commissioner, in assessing a deficiency against Tindall contended that a valid partnership existed between him and his son. Tindall, on the other hand, contended that no valid partnership existed. There, Tindall had conveyed an interest in his business to his son and took in return his son's promissory note which was to be paid out of the son's share in the profits. The Tax Court found against existence of a partnership solely on the ground that the son was a minor when the transaction was entered into. In so ruling, the Tax Court said:

"The cases cited by respondent in support of his argument that the son made a valid capital contribution are distinguishable. In *Atkins v. United States* (Dist. Ct., W. Dist. La.), 86 Fed. Supp. 342, the son, a minor, had his disabilities removed prior to signing the partnership agreement with his father. Moreover, though he borrowed \$20,000.00 of the cash that he contributed from his father, giving a note therefor, he later repaid the note out of profits, thus making an actual contribution to the capital of the partnership. Similarly, in *Green v. Arnold* (Dist. Ct., N. Dist. Tex.), 87 Fed. Supp. 255, the two minors who were held to be partners had given notes as

their capital contribution, which they later repaid out of profits. Here, as we have pointed out, the son's only contribution was a voidable note, which was never ratified, but, instead, was specifically avoided by him. The general rule is that an infant's disaffirmance of his contract nullifies it and renders it void *ab initio*. 43 C.J.S. 176. It is therefore our holding that the son made no capital contribution to the alleged partnership."

It is, therefore, submitted that the facts and circumstances above related and discussed show that the bargain made by Petitioners was not so unreasonable and so contrary to good business judgment as to leave no room for an honest difference of opinion as to its value to them. This being so, it is error for the Tax Court to override the considerations that impelled Petitioners to enter into a partnership arrangement with their children. The Tax Court also erred in giving no effect whatsoever to the good faith of the parties in making and performing their agreement.

---

### III.

**THE TAX COURT ERRED IN MAKING FINDINGS AND CONCLUSIONS THAT ARE CONTRARY TO THE RECORD AND IN FAILING TO CONSIDER AND MAKE FINDINGS ON EVIDENCE SHOWING THE CONDUCT OF THE PARTIES IN YEARS SUBSEQUENT TO THE TAX YEAR IN QUESTION.**

- A. It Was Error for the Tax Court to Disregard Undisputed and Convincing Evidence Disclosing the Bona Fide Performance of the Partnership Agreement.**

In demonstrating the errors contained in the findings and conclusions of the Tax Court it will be neces-

sary for us to discuss evidence in the record not considered by the Tax Court, and on which it made no findings. This evidence was admitted without objection on the part of Respondent and was relevant and material as to the issues presented to the Tax Court.

The Tax Court in the instant case has by a process of segmentation isolated the events which took place in the year 1943, and thereby has limited itself to a consideration of only these occurrences. We find no support for this either in the law or in the record. The agreement of the parties did not set a term for the expiration of the partnership, and the partnership was by its terms of indefinite duration and has operated for several years.

The case of *Grayson v. Deal*, 85 F. Supp. 431 (N.D., Ala., S.D., 1949), shows that evidence of events which occurred subsequent to the tax years in question may be considered in determining the reality of a partnership arrangement. In that case the Commissioner refused to recognize as valid a family partnership and assessed deficiencies against the plaintiff for the years 1943, 1944 and 1945. These deficiencies were paid subsequent to the tax years in question. After these deficiencies had been paid, the plaintiff's wife and children sought and obtained refunds of income taxes paid by them. The proceeds of the refunds were turned over to plaintiff by his family and he used them to pay the deficiencies assessed against him. The District Court considered this evidence and found that the partnership was invalid and in so doing said:



“When the plaintiff was called upon to pay the deficiency assessments here involved, the evidence shows that his wife and children promptly and willingly turned over their refund claims totaling some \$53,000, and the plaintiff applied these sums to the payment of his own assessments. These refund claims represented the income taxes that the other alleged partners had paid to the government because of monies earned by the business. Of course, plaintiff says that he expects to pay them back when the case is settled. However, he received these large sums from them without even going to the inconvenience of giving them any form of evidence of indebtedness. This is quite in contrast to the meticulous care and great particularity practiced in preparing and signing the various long, complicated, solemn agreements at the time the alleged partnership was formed. When this \$53,000 of the alleged monies of his wife and children was needed by Mr. Grayson, it was as readily available as any of his own funds.”

(85 F. Supp. 435.)

We submit that if evidence of events subsequent to the tax years in question may be used to prove the mala fides of a transaction such evidence may also be employed to show the bona fides of a transaction.

We are also supported in our contention by the fact that a partnership agreement does not become fully executed until the partnership relationship ends. In other words, the partners continue to perform the provisions of the agreement until the partnership is dissolved, and it is reasonable to conclude that evidence respecting this performance will shed light on



the bona fides of the transaction. This appears to be the view taken by the Supreme Court in *Commissioner v. Tower*, supra. There the Supreme Court said:

“When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their ‘agreement, considered as a whole, and by their conduct in execution of its provisions’.” (citing cases) (Emphasis supplied.)

\* \* \* \* \*

“The issue is who earned the income and that issue depends on whether this husband and wife really intended to carry on business as a partnership. *Those issues can not be decided simply by looking at a single step in a complicated transaction.*” (Emphasis supplied.)

(327 U.S. 286-287; 289-290, 90 L.Ed. 675; 677.)

The foregoing expressions of the Supreme Court indicate that the conduct of the parties subsequent to the tax years in question is relevant. Therefore, the Tax Court erred through its failure to consider this evidence, and its action in basing its findings on only part of the record.

“It is suggested that this Court should accept the findings of the Board; that contradictions, inconsistencies, and erroneous inferences are immune from criticism or attack by Section 10(e) of the Act, 49 Stat. 453, 29 U.S.C.A. §160(e), which provides that ‘the findings of the Board as to the facts, if supported by evidence, shall be

conclusive' *But the courts have not construed this language as compelling the acceptance of findings arrived at by accepting part of the evidence and totally disregarding other convincing evidence.*" (Emphasis supplied.)

*N.L.R.B. v. Union Pacific Stages*, 99 F. 2d 153, 177 (C.C.A. 9, 1938.)

- B. The Tax Court Erred in Finding That During the Year 1943 the Business of the Partnership Was Still Completely Under the Control of Harkness, Sr. This Finding Is Contrary to the Record and Fails to Give Effect to the Intent and Good Faith of the Parties.**

The Tax Court seeks to support its decision herein by finding that:

"During the year 1943, there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr." (R. 270).

In its opinion, the Tax Court maintains that evidence in support of this finding is to be found in the partnership agreement, the supplementary agreement of January 4, 1943, the actual conduct of the partnership business during 1943, and in the testimony of Harkness, Sr. In this connection the Tax Court said:

1. "Turning to the partnership agreement, it also refutes an intent by the signatories to join together in the present conduct of the affairs of United Packing Co., but rather shows an intent that Harkness, Sr., continue to control the conduct of the business as in prior years, when he was sole proprietor. The parties therein agreed that neither Harriet, young Harkness nor Molly

Harkness would devote any time to carrying on the business unless thereafter agreed upon, but that Harkness, Sr., would be general manager thereof in full charge of all business operations which he might conduct as he chose. Harkness was given full charge of the books of accounts of the partnership and of the collection and expenditures of money taken in. His consent was necessary to bind the partnership in any business transaction and to lower or raise partnership capital. His participation was necessary in the adjustment of any misunderstanding between the partners as to the conduct of the business and in the determination of the proper allocation of profits and losses among the partners" (R. 277, 278).

2. "The supplementary agreement of January 4, 1943, also contradicts any intent on the part of the alleged partners to join together their services in the conduct of United Packing Co. in 1943. By its provisions Harkness, Sr., alone was to receive compensation for services because he was to be the only active partner in the business for the duration of the war" (R. 278).

3. "Finally, the actual conduct of the business of United Packing Co. in 1943 makes it clear that the parties intended for Harkness, Sr. to operate it as a sole proprietor for the duration of the war. Young Harkness and Harriet Colgate rendered no vital services, nor did they participate in the management of the business during that year. Harriet was absent from Fresno the entire time. While by chance young Floyd was stationed in California during almost all of 1943 and frequently visited the company's plant on weekends to talk over business conditions with



his father, yet such visits hardly bespeak an active role in the conduct of the company, but rather a continuing interest therein by a prospective participant. The evidence reveals only one transaction, the purchase of River Ranch, where the approval of his children was sought by Harkness, Sr.” (R. 278, 279).

4. “Harkness, Sr., frankly admitted in his testimony that the conduct of the company’s business was not altered in 1943, but remained essentially the same as in 1942, when he operated United Packing Co. as a sole proprietor” (R. 179).

The evidence discussed by the Tax Court does not support its findings. Support, if any, for these findings is to be found only in the erroneous inferences drawn from this evidence by the Tax Court.

The assertion that the business was still under the complete control of Harkness, Sr., during 1943, is contradicted by other evidentiary findings made by the Tax Court. We refer to the following:

1. “On December 31, 1942, ‘Articles of Partnership’, providing the detailed terms of the proposed partnership, were drafted and met the approval of all but Harriet Colgate, *who refused to sign until provisions as to control of the business and as to purchase of a deceased partner’s share were modified*” (Emphasis supplied) (R. 257):

2. “During January, 1943, Harkness, Sr., discussed with the Colgates the modifications sought by Harriet Colgate in the partnership agreement drafted on December 31, 1942. *Harriet withdrew*



*her objections when the original draft was altered to meet her demands* (Emphasis supplied) (R. 259).

The testimony of Harriet Colgate underlying the above quoted findings also contradicts the assertion that Harkness, Sr., completely controlled the business. This testimony is as follows:

“Q. What did you do? Did you convey those objections to your family?

A. Yes, I did.

Q. Will you please explain to the Court just what you conveyed to your family and why you didn't sign the document?

A. Well, there were several stipulations in it that I didn't agree to, and as my husband had signed the note with me, which made him as liable for this amount we borrowed, he and I discussed it, and we just didn't agree to them.

Q. Can you recall what you didn't agree to generally, not in detail, but generally so the Court may have that picture?

A. That my mother and father, Molly A. and Floyd Harkness, *had too much power*, and in case of death there were several stipulations that we didn't agree to.

Q. You wrote that to your family?

A. Yes, we did.

Q. Subsequently was a new document sent to you or did your father and mother bring you one, or what occurred?

A. I believe my mother and father came shortly after that, and we had a long discussion about it. In March, after lengthy correspondence about it, the document was sent in March which we did agree to” (Emphasis supplied) (R. 200).

It is apparent from the foregoing that Harriet Colgate demanded at least that Harkness, Sr., have less than complete control of the business and that this demand was met. The Tax Court, however, assumed that the provisions of the agreement were without force and effect. This assumption results from the Tax Court's refusal to give effect to the good faith of the parties and from its refusal to give effect to the intent of the parties. This clearly indicates, as we have said before, that the Tax Court, contrary to the mandate of the *Culbertson* case, found itself free to disregard the intent of the parties as evidenced by their agreement, once it found to its satisfaction that the children had contributed neither original capital nor vital services.

The Tax Court seized upon the provision of the agreement giving certain enumerated powers to Harkness, Sr., to bolster its claim that Harkness, Sr., exercised complete control of the business. This, of course, is based on the erroneous premise, that Harkness, Sr., exercised the powers given him by the agreement, not as a partner and as an agent for the absent members, but as a sole proprietor, and in complete disregard of the partnership relationship. This conclusion likewise results from the Tax Court's failure to give effect to the intent and good faith of the parties, including Harkness, Sr. Although, as we have said before, the Tax Court failed to give effect to the good faith of the parties, it did not discredit their agreement as a sham or a device to avoid taxes. This being so the partnership agreement must be read in the

light of the intent of the parties, and if it is so read, the binding legal effect of its provisions must be considered in reviewing the findings of the Tax Court.

In considering whether or not complete control was retained by Harkness, Sr., over the assets, business and profits of the partnership, it is well first to inquire into the extent of his powers and control over the same property prior to the formation of the partnership. It is conceded that all the property of the Petitioners, including that transferred to the partnership, was community property. Under the community property laws of the State of California, the husband's powers of management and control are exclusive and absolute. *Section 172 of the Civil Code of the State of California*, expressly confers such powers upon the husband.

“The husband has the management and control of the community personal property, *with like absolute power of disposition*, other than testamentary, as he has of his separate estate; provided, however, that he cannot make a gift of such community personal property, or dispose of the same without a valuable consideration, or sell, convey, or encumber the furniture, furnishings, or fittings of the home, or the clothing or wearing apparel of the wife or minor children that is community, without the written consent of the wife.” (Emphasis supplied.)

*Section 172a* gives the husband the same power of management over the community real property.

Indeed, so exclusive and extensive are the husband's powers of management and control, that even



his abandonment of the wife, or the fact that he has disappeared gives her no special power over the community property (*Chance v. Kobested*, 66 Cal. App. 434, 226 P. 632 (1924)). As can be seen from Sections 172 and 172a of the Civil Code, the only limitation placed over the husband's powers of management and disposition of the community property is that he cannot make a gift of it or dispose of it without valuable consideration.

The most cursory examination of the partnership agreement and the supplements thereto make it evident that the unfettered command and control which Harkness, Sr., formerly had over the properties conveyed to the partnership have been substantially curtailed and diminished. Prior to the formation of the partnership his right to bind the property was unlimited. The partnership agreement, on the other hand, requires that the general manager and one other partner act together to bind the business. The partnership agreement provides:

“It is understood and agreed that the said first party as general manager, and anyone of the other co-partners acting together shall have the right to bind the said co-partnership in such manner or form as they may deem necessary in order to carry on the business of the said co-partnership, and that no other co-partner shall have the right to in any manner bind the said co-partnership, \* \* \*” (R. 263-264).

The power conferred by the original agreement on Harkness, Sr., to bind the partnership was further



limited by the supplement executed as of January 16, 1945 (R. 37-41, Exhibit 2-B). This supplement provides in part as follows:

“\* \* \* it shall now become necessary that first party and any two of the co-partners acting together with the said general manager shall have the right to so bind the said co-partnership” (R. 39).

The powers of Harkness, Sr., were also diminished in other respects. Prior to the formation of the partnership he could, at his pleasure, increase or reduce the working capital of the business, but upon the formation of the partnership this power ceased to exist. The partnership agreement provides as follows:

“It is understood and agreed by and between the parties hereto that upon the consent of the managing partner and two of the remaining partners that the capital of the partnership may be increased to such sum as may be determined by them, and that thereafter each of the partners shall contribute their respective share of the capital increase. In the event the managing partner and two of the other partners desire to reduce the capital of the partnership or withdraw profits, then such determination shall become binding upon all the partners hereto” (R. 265).

Before the formation of the partnership, Harkness, Sr., determined at will the salaries to be paid to those rendering services to the business, except, perhaps in those instances where the employees had superior bargaining power. Under the partnership agreement, however, the salaries to be paid to the

partners rendering services to the partnership cannot be fixed by Harkness, Sr., alone, but are to be determined by agreement between any three of the co-partners. In this respect, the partnership agreement provides:

“ . . . and at that time it shall be agreed upon by and between any three of said partners as to what the compensation shall be for the services which third or fourth partner may contribute towards the carrying on of said co-partnership business” (R. 264).

As manager of the community, and when the business was being conducted as a sole proprietorship, Harkness, Sr., had no duty to account or give information in connection with his conduct of the business. After the formation of the partnership he was compelled, under the express terms of the agreement, to account and to give information to the other partners with respect to the conduct of the business (R. 265). The control of Harkness, Sr., was also curtailed by the provisions of the *California Civil Code* applicable to the partnership relation. Before the formation of the partnership the Petitioners were the sole owners of the property involved. Thereafter, by operation of law, they were co-owners thereof with their children, and their right to possess it, theretofore unlimited, could only be exercised for partnership purposes (*California Civil Code*, Sec. 2419).

The agreement provides in the following terms that Harkness, Sr., shall be general manager of the co-partnership:

“It is understood and agreed by and between the said co-partners that said first party shall be, and is from this date on made the general manager of said co-partnership and that he shall be in full charge of all business operations of said co-partnership and that he shall have the full right to conduct the business of said co-partnership in such manner as he may desire, including the selling of any and all of the partnership assets and the purchasing of such other property as he may desire in the name of said co-partnership together with the right to borrow such money as he may deem necessary to carry on said business and in consideration thereof it is understood and agreed that first party is to receive for his said services a certain percentage of the net profits of said business to be agreed upon between all of the partners herein from time to time as they may agree upon between themselves, \* \* \*” (R. 262-263).

In addition, the agreement conferred upon Harkness, Sr., and one other partner the power to determine any question which might arise between the co-partners. This power was curtailed by an amendment contained in the supplement of January 16, 1945, where the following appears:

“\* \* \* in the event of any misunderstanding between the co-partners concerning the matter of conducting and carrying on of said business, that the decision of the general manager and one other partner shall determine any question \* \* \*” (R. 40).



We submit that the powers vested in Harkness, Sr., by the provisions of the agreement should not be considered in the nature of a grant of a privilege, but rather the assumption of a duty and a responsibility so onerous that the agreement provided that Harkness, Sr., should receive a salary in consideration of the performance by him of those duties, in addition to his profits.

It is also submitted that under the circumstances of the case it was most natural and reasonable that the powers of management should be vested in Harkness, Sr. When the partnership was first formed it was evident to everyone that both Harkness, Jr., and Colgate would be absent for an indefinite period, and this required the assumption of management powers by the most experienced and unquestionably the most capable member of the partnership.

Moreover, as the Board of Tax Appeals once observed:

“A partnership not infrequently has a manager.”

(*George Bros. & Co. v. Commissioners*, 41 B.T.A. 287, 293 (1940).)

Decisions of the California Appellate Courts, as well as decisions of the Tax Court, are authority for the proposition that the fact that the power of management is conferred upon one of the partners does not negative the existence of the partnership. In the California case of *Lyon v. MacQuarrie*, 46 Cal. App. (2d) 119, 115 Pac. (2d) 549 (1941), the following is stated in support of this proposition:



“That there was no complete control of every part of the venture vested in each partner does not negative the existence of a partnership, for, by agreement, one partner may be given the duty of management of the partnership enterprise or any part of it. (*Thompson v. O. W. Childs Estate Co.*, 90 Cal. App. 552, 266 Pac. 293; *Associated Piping & Engineering Co., Ltd. v. Jones*, 17 Cal. App. (2d) 107, 61 Pac. (2d) 536.)”

In the case of *J. A. Riggs Tractor Co. v. Commissioner*, 6 T.C. 889 (1946), the Commissioner contended, among other things, that because of a certain management provision, the partnership there in question was not a partnership, but an association. The management provision in the *Riggs* case read, in part, as follows:

“\* \* \* provided that in the event of a disagreement or difference in opinion between the partners as to any matter of policy or any action to be taken or omitted in the conduct of the partnership business, the judgment of John A. Riggs, Sr., \* \* \* shall be controlling, and shall determine the policy to be adopted and the action to be taken or omitted.” (Emphasis supplied.)

(6 T.C. 892.)

The Court will note that by its very generality the above quoted provision conferred upon Riggs, Sr., powers which were by far more extensive than those granted to Harkness, Sr. Notwithstanding this last mentioned fact, the Tax Court held that this was not incompatible with the existence of a true partnership, and in so doing stated the following:

“The fact that Riggs, Sr. was given a controlling vote in the event of a disagreement between the partners or a difference in opinion as to a policy to be adopted does not alter the case. *It is not uncommon for a partnership to have a managing partner. Cf. George Bros. & Co., supra. Certainly, that part of the partnership agreement giving Riggs, Sr. this veto power is not so rare a provision in partnership agreements as to require our holding that this enterprise was more than an ordinary partnership. It is not an uncommon feature in partnership agreements.* We are unable to discern any real distinction between the management and control of petitioner’s business and the management and control of the business of ordinary partnerships. We are satisfied that the operations and business conduct of petitioner more closely resemble the operations of an ordinary partnership than the operations of a corporation.” (Emphasis supplied.)

(6 T.C. 897, 898.)

The only conclusion to be drawn from the foregoing is that the former unfettered power and control which Harkness, Sr., once had, have been effective and substantially limited and diminished by the terms of the partnership agreement, and by the provisions of the California Civil Code applicable to the partnership relation. In addition, the foregoing also demonstrates that the powers of management vested in Harkness, Sr., have, under the facts of this case, a reasonable basis and are, under the authority of the decisions of the Tax Court and other Courts entirely consistent with, and do not negative the existence of a true partnership.

It is respectfully submitted in the light of the foregoing, that because of the terms of the parties' bona fide agreement Harkness, Sr., did not have the control of a sole proprietor of the business of United Packing Company in 1943.

The Tax Court next seeks to support its findings on erroneous and invalid inferences drawn from the provisions of the supplementary agreement of January 4, 1943. The Tax Court draws an inference of lack of intent from the fact that this agreement contemplated that for the duration of the war Harkness, Sr., was to be the sole active partner and was to be paid a salary commensurate to the responsibilities assumed by him. From the provisions of this instrument and from the further circumstance that Harkness, Sr., was the only partner that was active in 1943, the Tax Court draws the following additional erroneous inference:

“\* \* \* the income of United Packing Co. for 1943 was earned by the efforts of Harkness, Sr., and the capital contributed by both petitioners rather than from the services or capital contributions of the son and daughter” (R. 279-289).

These erroneous inferences overlook that the services performed by Harkness, Sr., were not performed by him as a sole proprietor but as an employee and agent of the partnership. These inferences likewise ignore that capital of which the children were “true owners” was being employed in the operations of the partnership. Lastly, these inferences also ignore that important services were rendered by Chris Sorenson, another employee of the partnership, during the year



in question, and that the partnership, not Harkness, Sr., paid this employee substantial compensation for his services. Exhibit 5-E, attached to the stipulation of facts (R. 53-54), shows that Sorenson received from the partnership for his services the sum of \$53,283.39. In addition, Sorenson received as his share of the profits from the operation of the "River Ranch" by the partnership the sum of \$60,309.92 (Exhibit 4-D, R. 52). In this connection it should be recalled that all the funds necessary for the purchase of the "River Ranch" were advanced by the partnership (R. 269-270).

In the case of *Greenberger v. Commissioner*, supra, the respondent sought to prevail on the basis of similar erroneous inferences drawn by the Tax Court from the evidence. In that case the petitioner had formed a family partnership with his wife and minor children. The children and the wife rendered no services, and the facts showed that the income of the partnership had been earned through the personal services of the petitioner and other employees of the partnership. The Tax Court held, therefore, that all the income of the partnership should be taxed to the Petitioner. The Court of Appeals for the Seventh Circuit reversed the Tax Court. The Court of Appeals determined that the partnership was bona fide and on the basis of this determination found that the income belonged to the partnership and not to the Petitioner. In this connection the Court of Appeals said:

"Another contention closely tied in with the lack of capital as an income producing factor is



that petitioner by the rendition of personal service was responsible for production of the income. It is true the court in *Tower* stated, 327 U.S. at page 289, 66 S. Ct. at page 537, 'The issue is who earned the income,' but the court also stated, 'that issue depends on whether this husband and wife really intended to carry on business as a partnership.' *If the partnership in the instant case was bona fide, as we think it was, the income earned was that of the partnership and not that of petitioner.* While petitioner undoubtedly was the predominating force in the conduct and management of the business, the Commissioner overlooks the fact that the partnership paid him a salary of \$45,000 per annum during each of the taxable years for his services thus rendered. In this connection, it is pertinent to note that only 24% of the partnership's income for 1943, and 37% for 1944, were attributable to commissions earned by petitioner. The remainder of the income was attributable to commissions earned by other employees, called sales engineers. *The Commissioner, in our view, erroneously treats these sales engineers as employees of petitioner rather than of the partnership.*" (Emphasis supplied.)

(177 F. (2d) 994.)

The Tax Court attempts to find further support for its invalid finding in the fact that, so far as the record shows, the children were consulted only with reference to one transaction during the year 1943. This transaction involved the purchase of the "River Ranch." This fact does not aid the Tax Court. This transaction was the only transaction during the year 1943 which was not in the category of those that may

be classified as being within the ordinary course of the business of the partnership. This was an extraordinary transaction, which entailed among other things the advancing of funds for the purchase of Sorenson's interest. This demonstrates very clearly that when Harkness, Sr., sought and obtained the consent of his children before entering into the transaction, he realized that he was not a sole proprietor and that he was cognizant of his partnership obligations.

As a final point in support of its contentions, the Tax Court states that Harkness, Sr., admitted that the conduct of the business in 1943 remained essentially the same as in 1942, when he operated it as a sole proprietor (R. 279). In appraising the validity of this point we should refer to the testimony on which it is based. This testimony is as follows:

“Q. Now, after the agreement of December 31, 1942, what change was made in the conduct of the business?

A. No change could be made immediately. I had to continue along paying the high bonuses, high salaries, and putting in an extra lot of hours myself.

Q. Continued just the same as it had prior to 1942, didn't it?

A. No. We had a lot more troubles in '43 and '44 than we ever had in '42.

Q. Well——

A. The war was on, Mr. Mather.

Q. The war was on in '41?

A. December 8, 1941, we actually declared war, pretty near the end of the year.

Q. How did your business change in its operation after your agreement of December 31, 1942?

A. Let me——

Q. Just answer my question if you can.

A. How did the business operations change?

Q. Yes.

A. They didn't change.

Q. When was the first time they changed after your agreement of December 31, 1942?

A. Well, with the return of Mr. Colgate in October, 1944, that is the first time that one of the partners participated" (R. 152-153).

The above quoted portion of the record shows very general answers to very general questions propounded to the witness on cross examination by counsel for the Respondent, and their content demonstrates that by a change of operation the witness had in mind merely an actual participation in the conduct of the business by the other partners, and not other changes as to which there is abundant evidence. It is apparent also that this testimony has no bearing on the issues. We know of no case, and the decision of the Tax Court fails to mention any, which would require a *change* in the manner of operating a demonstrably successful business as a condition precedent to establishing the bona fides of a partnership formed to acquire and operate such a business.

We submit that all of the foregoing shows, as we have said before, that the findings and decision of the Tax Court result solely from its resort to the invalid original capital-vital services tests.



**C. The Tax Court Erred in Concluding That Petitioners' Children Did Not Have Unhampered Enjoyment of Their Respective Shares of the Proceeds of the Business. This Conclusion Is Unreasonable and Contrary to the Record.**

In *Commissioner v. Culbertson*, supra, the Supreme Court stated that if a participant in a partnership arrangement is free to, and does enjoy the income of the partnership, this fact gives a strong indication of the reality of the arrangement.

“If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise.” (337 U.S. 747; 93 L.ed. 1668.)

There is abundant evidence in the record to show that Petitioners' children were at all times free to enjoy their respective shares of the profits of the business. In the statement of the facts we have shown that Petitioners' daughter and her husband withdrew in the period 1943-47 the sum of \$100,138.48 as and for salary and net profits from the business, and that Petitioners' son during the same period withdrew salary and profits in the sum of \$121,484.51. It should be remembered that these withdrawals do not include sums used for the payment of taxes.

The Tax Court attempts to destroy the effectiveness of this evidence by disregarding the free enjoyment of profits by Petitioners' children in the years subse-



quent to 1943 and by seizing on the circumstance that the children had pledged the first profits to the payment of their notes. In this connection the Tax Court said:

“Furthermore, the Harkness children had no unhampered enjoyment of their share of the profits, for net income accruing to them was first to be turned over to Harkness, Sr., and applied to any payments he may have advanced to them and the balance was then to be applied on the promissory notes executed in his favor” (R. 278).

This conclusion is unreasonable. It is premised on the absurd proposition that a debtor does not own or enjoy income if he employs it to pay his debts. This proposition is unreasonable even when judged in the abstract, but the extent of its absurdity is emphasized when considered in the light of the facts of this case. The evidence shows that Petitioners' children and their son-in-law greatly desired to become associated with the family business. The evidence also shows that in order to satisfy this desire they would have to pay for their interests in the business, because Harkness, Sr., did not believe in giving his children anything but the opportunity to make good (R. 148). Therefore, in the making of the bargain the children satisfied their desire and Harkness, Sr., his beliefs, by an agreement that the first profits of the partnership be used to pay the notes.

This makes it evident that when the children disposed of their right to receive part of their income in order to satisfy their desire to become co-partners in

the business, they enjoyed the fruits of their investment to the same extent as if they had not disposed of their right to collect it. As authority for this proposition we rely on the following taken from *Helvering v. Horst*, 311 U. S. 112, 116-117, 85 L. ed. 75, 78 (1940):

“If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, see *Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U. S. 716, 73 L. ed 918, 49 S Ct 499, *supra*; *Bowers v. Kerbaugh Empire Co.*, 271 US 170, 70 L ed 886, 46 S Ct 449; *United States v. Kirby Lumber Co.*, 284 US 1, 76 L ed 131, 52 S Ct 4, or if he sets up a revocable trust with income payable to the objects of his bounty, §§ 166, 167, Revenue Act of 1934, 26 USCA Int. Rev. Acts 1940 ed. p. 727; *Corliss v. Bowers*, 281 US 376, 74 L ed 916, 50 S Ct 336, *supra*; cf. *Dickey v. Burnet* (CCA 8th) 56 F (2d) 917, 921, he does not escape taxation because he did not actually receive the money. Cf. *Douglas v. Willcuts*, 296 US 1, 80 L ed 3, 56 S Ct 59, 101 ALR 391; *Helvering v. Clifford*, 309 US 331, 84 L ed 788, 60 S Ct 554.

“Underlying the reasoning in these cases is the thought that income is ‘realized’ by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. *The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to*

*procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. Cf. Burnet v. Wells, 289 US 670, 77 L ed 1439, 53 S Ct 761, supra.”* (Emphasis supplied.)

The Tax Court has entirely overlooked that the children through this pledge of income got something of substantial value which they contributed to the capital of the co-partnership. This, too, illustrates that the Tax Court completely lost sight of the Supreme Court's mandate to find whether the Petitioners' children were bona fide partners “because of contribution of capital of which they were the true owners”.

---

### CONCLUSION.

The record in this case shows without contradiction, that Petitioners' children were the true owners of the capital they contributed to the partnership. This fact, taken together with all the other facts in evidence, establishes that the parties really and truly intended to join together for the purpose of carrying on a business and sharing in its profits and losses. There is no evidence that the partnership was a mere sham utilized for the purpose of reducing the Petitioners' true tax liability by a pretended distribution of income. Measured by every test, the evidence discloses that the arrangement here in question fulfills all the conditions necessary to qualify it as a valid partnership for income tax purposes. The Petitioners have,

therefore, effectively carried the burden of showing the reality of their partnership.

It is submitted that the decision of the Tax Court should be reversed.

Dated, San Francisco, California,  
November 10, 1950.

Respectfully submitted,

PHILIP S. EHRLICH,

ALBERT A. AXELROD,

R. J. HECHT,

IRVING ROVENS,

*Attorneys for Petitioners.*

**(Appendix Follows.)**



## **Appendix.**



## Appendix

---

### ARTICLES OF CO-PARTNERSHIP

These Articles of Co-Partnership, made and entered into this 31st day of December, 1942, by and between Floyd J. Harkness, first party; Molly A. Harkness, second party; Floyd James Harkness, Jr., third party; and Harriet Harkness Colgate, fourth party, the first, second and third parties being residents of the County of Fresno, State of California, and fourth party being a resident of Columbus, Franklin County, Ohio:

#### WITNESSETH:

That the said parties hereto for themselves, their heirs, executors, administrators and assigns agree to become co-partners in the business of carrying on a general business of growing, packing, shipping and distributing of fresh fruit and vegetables in the State of California, including the purchasing and selling of any and all kinds of real and personal property necessary in carrying on and conducting said business, and said business shall be conducted under the firm name and style of "UNITED PACKING CO." from January 1st, 1943 until such time as the said co-partners shall mutually agree to dissolve said co-partnership, or the said co-partnership shall be otherwise as hereinafter provided dissolved, and that the terms upon which the said parties have entered into said co-partnership are hereinafter stated as follows, to-wit:

That the said business of growing, packing, shipping and distributing of fresh fruit and vegetables and any other business which shall be incidental and necessary thereto, shall be carried on in the State of California and that the principal place of business of said co-partnership shall be in the Rowell Building in the City of Fresno, County of Fresno, State of California or at any other place or places as the partners shall hereafter determine and that the firm name and style of said co-partnership business shall be UNITED PACKING CO., with real and personal property belonging thereto located in the Counties of Kern, Tulare, San Joaquin and Fresno, State of California.

It is understood and agreed by and between the parties hereto that said first party has been conducting the above mentioned business individually under the firm name and style of United Packing Co., and that he and Molly A. Harkness, his wife, second party herein, have been the owners of all the real and personal property, equipment and materials that are now used in carrying on said business, together with such moneys as may now be on deposit in the name of the said United Packing Co. and together with any and all outstanding accounts owing as of this date, the said Floyd J. Harkness and Molly A. Harkness, first and second parties herein, do by these presents, sell, convey and set over, an undivided one-fourth partnership interest in and to all of the partnership property of the United Packing Co. to each of the third and fourth parties, namely, Floyd James Harkness, Jr.,



and Harriet Harkness Colgate, and from this date on each of the said co-partners above named, shall be and become the owners of an undivided one-fourth interest of all of the property of the said co-partnership doing business under the firm name and style of United Packing Co. and that the real and personal property which shall compose the capital of the said co-partnership and belong to the newly organized co-partnership is described in a Schedule marked Exhibit "A" and attached hereto and made a part of this agreement as if herein fully set out, and that there shall also belong to said co-partnership any and all other assets which now belong to said co-partnership and are not herein described as well as any and all other assets which may hereafter belong to said co-partnership; that all thereof shall belong equally to all of the partners herein named and in consideration of said first party conveying all of said real and personal property to said co-partners being conducted under the firm name and style of the United Packing Co., and which is agreed to be of the net value of \$138,241.61, that the said third and fourth party shall each execute in favor of first party a promissory note in the sum of \$34,560.40 payable in the manner as herein set forth to first party, and which sum shall be the purchase price for their undivided one-fourth interest in and to all of the assets of said co-partnership.

It is understood and agreed by and between the parties hereto that the said first and second parties are husband and wife and that all of the property which said first party is on this date conveying to the

newly-formed co-partnership, in which all of the above named parties are equal partners, has been accumulated by first and second parties during their married life and is the community property of first and second parties and that one-half thereof, by reason thereof, is the property of said second party and that the said second party does herewith join first party in the conveying of all of the said assets herein described to the said co-partnership so that from this date on, all of the said property now belonging to the said United Packing Co. and any and all other property which may hereafter belong to said co-partnership shall be owned equally by all the said co-partners.

It is understood and agreed by and between the said co-partners that said first party shall be, and is from this date on made the general manager of said co-partnership, and that he shall be in full charge of all business operations of said co-partnership and that he shall have the full right to conduct the business of said co-partnership in such manner as he may desire, including the selling of any and all of the partnership assets and the purchasing of such other property as he may desire in the name of said co-partnership together with the right to borrow such money as he may deem necessary to carry on said business and in consideration thereof it is understood and agreed that first party is to receive for his said services a certain percentage of the net profits of said business to be agreed upon between all of the partners herein from time to time as they may agree upon between them-

selves, and that the balance of the net income of said co-partnership shall be equally divided between all of the co-partners herein at such time or times as they may agree upon, provided however that any profits which third and fourth parties are entitled to receive shall be paid to first party and applied by him first, to any payment which first party may have advanced to third and fourth parties, together with interest thereon and the balance thereof, if any, shall be applied by first party in the payment of the promisory notes which the said third and fourth parties have executed in favor of first party for the purchase price of their share in said co-partnership business.

It is understood and agreed that the said first party as general manager, and any one of the other co-partners acting together shall have the right to bind the said co-partnership in such manner or form as they may deem necessary, in order to carry on the business of the said co-partnership, and that no other co-partner shall have the right to in any manner bind the said co-partnership, and that no co-partner shall have the right to in any way sell, assign, set over, transfer or hypothecate his undivided one-fourth interest in said co-partnership without first obtaining the written consent of two other co-partners.

It is understood and agreed that said first party as general manager of said co-partnership shall devote such portion of his time and attention to the conducting and carrying on of said business, as he shall deem necessary and proper but that he will at all times use



his own good judgment and best efforts and experience in carrying on said business for the best interests of all parties concerned and that second, third and fourth parties shall not devote any time or attention in carrying on said business unless hereafter agreed upon by and between any three of said co-partners and at that time it shall be agreed upon by and between any three of said partners as to what the compensation shall be for the services which third and fourth partner may contribute towards the carrying on of said co-partnership business.

It is understood and agreed that there shall be kept at all times a complete set of books of account wherein there shall be entered any and all records and transactions of said business and that the said first party shall have complete charge thereof and that said books shall be under his immediate supervision and that the said first party shall have the full charge of the collections and expenditures of all of the moneys received and taken in, in the carrying on of said business, and that all of the business transactions of said first party in carrying on said business shall be binding on all of the said co-partners.

It is understood and agreed in this connection that first party will render on the 1st of each year a true and full statement and account of the profits or losses of said business and all other matters and transactions done and performed in connection with said business.

It is understood and agreed by and between the parties hereto that upon the consent of the managing



partner and two of the remaining partners that the capital of the partnership may be increased to such sum as may be determined by them, and that thereafter each of the partners shall contribute their respective share of the capital increase. In the event the managing partner and two of the other partners desire to reduce the capital of the partnership or withdraw profits, then such determination shall become binding upon all the partners hereto.

It is further understood and agreed by and between the parties hereto that each one of the partners will not, without the previous consent in writing of the other partners, enter into any bond or become bail or security for any person or persons or do or suffer to be done anything whereby the capital or property of the co-partnership may be taken by execution and that each partner shall punctually pay his own separate debts and should any one of the said co-partners become financially involved in outside interests so that his share in the said co-partnership business shall become involved, and should any one of said co-partners in any manner so become involved then the other co-partners shall have the right to acquire such insolvent partner's right, title and interest in said co-partnership at the book value thereof without any consideration of the good will of the said co-partnership and upon such transfer, such insolvent partner shall have no further right, title and interest in and to the capital assets of the said co-partnership.

It is understood and agreed that in the event that any one of the said co-partners desire to sell or in any

way dispose of their interest in the said co-partnership business, that then the remaining co-partners shall have the right to purchase such partner's interest in said co-partnership and then the selling co-partner shall convey all of his right, title and interest in and to the said co-partnership property to the remaining co-partners, and shall receive for such conveyed interest the book value of such interest at said time without any consideration of the good will of the co-partnership and that the amount which the selling co-partner shall receive may be paid in cash by the remaining co-partners, but if the remaining co-partners do not desire to pay cash for the selling partner's interest, then they shall have the right to pay such amount by the application of the profits from the business of such selling partner's share and that the same shall continue to be paid in this manner until the said purchase price of such selling partner's interest in said co-partnership shall have been paid in full, and then such selling partner shall execute in favor of the remaining co-partners a Bill of Sale conveying all his right, title and interest in and to the said co-partnership business and assets to the remaining co-partners.

It is understood and agreed by and between the parties hereto that should any one of the partners become deceased, that then the remaining co-partners shall have the right to purchase such deceased partner's share in said business at the book value at the time of the death of such co-partner without any consideration of the good will of the partnership and such

deceased partner's interest in said business shall be paid to the legal representative of such deceased partner and then the legal representative of such deceased partner's estate shall convey all of the deceased partner's right, title and interest in and to the said co-partnership property to the remaining co-partners and the legal representative of such deceased partner shall receive for such conveyed interest the purchase price for such deceased partner's interest which may be paid in cash by the remaining co-partners or if the remaining partners do not desire to pay cash for such deceased partner's interest, then they shall have the right to pay such amount by the application of the profits from the business of such deceased partner's interest and that this method of payment shall continue until the said purchase price of said deceased partner's interest shall have been paid in full and that upon such payment in full of the purchase price of said deceased partner's interest in said co-partnership the legal representative of such deceased partner shall execute and deliver to the remaining co-partners a Bill of Sale conveying all of the said deceased partner's interest in the said co-partnership business and assets.

It is also agreed by the co-partners that in the event of any misunderstanding between the co-partners concerning the matter of conducting and carrying on of said business that then the partners shall, between themselves adjust the same; it is however understood in this connection that the decision of the general manager and one other partner hereto shall



determine any question which may arise between them and in the event that anyone or more of said co-partners should be dissatisfied with such decision then they shall have the right as given them by the laws of the State of California to bring proceedings in court for the purpose of either dissolving the said co-partnership or obtaining such relief as they are entitled under the terms of this co-partnership.

It is further understood and agreed that this co-partnership business is entered into on the proposition that each partner has an equal interest therein and is entitled to an equal share in all gains, profits and increases which shall come, grow or arise from, or by means of said business so long as such partner or partners shall not be in default in any of the terms of this agreement and that each partner shall be entitled to his one-fourth share of the said profits and that each partner shall likewise share equally in any losses which the said partnership may sustain and that each partner shall in the event it becomes necessary to furnish additional funds by reason of any losses which the said partnership may sustain, then each partner shall furnish and pay into the said business his equal share which may be necessary in order to continue on with the said co-partnership business. It being agreed that the decision of the managing partner and any two of the remaining partners shall be final as to the matter of the division of the profits and the amount which may be paid in by each partner in the event it becomes necessary to do so on account of losses sustained by the said co-partnership.



That at the end or sooner determination of their co-partnership, the said co-partners, each to the other, shall and will make a true, just and final accounting of all things relating to their said business, and in all things truly adjust the same; and that all and every stock and stocks, as well as the gains and increase thereof, which shall appear to be remaining, either in money, goods, wares, fixtures, debts or otherwise, shall be divided between them, share and share alike.

IN WITNESS WHEREOF, the above named partners have hereunto set their hands and signatures the day and year first above written.

---

First Party.

---

Second Party.

---

Third Party.

---

Fourth Party.



## EXHIBIT "A"

## FINANCIAL STATEMENT—UNITED PACKING CO.

1/1/43

<b>Assets</b>			
Cash .....			\$100,000.00
Lodi Jap Camps			428.77
Packing Sheds .....	\$21,615.15		
Less: Depr. Reserve	15,966.41		5,648.74
<hr/>			
Real Estate—Parlier			1,500.00
Registered Brands			1,230.00
Auto Equipment	9,025.96		
"    "	2,925.58		6,100.38
<hr/>			
Firebaugh Ranch	2,944.50		
"    "	1,898.24		1,046.28
<hr/>			
Otani Tractor	1,290.56		
"    "	151.15		1,139.41
<hr/>			
Box Making Machine	750.00		
"    "	750.00		0
<hr/>			
Peach Brushers	2,271.11		
"    "	2,271.11		0
<hr/>			
Paper Trays			504.18
Office Equipment	2,354.03		
"    "	1,293.03		1,061.00
<hr/>			
Packing Equipment	12,288.81		
"    "	8,976.86		3,311.95
<hr/>			
Picking Boxes			6,182.60
Packing Materials			6,473.31

## Accounts Receivable:

Andrews Bros.	164.50
Benner Tea Co.	2,365.00
H. H. Bennett	222.30
Mrs. Blazer	575.00
P. V. Cervantes	40.00
P. B. Elter	74.45
Goodman Vyd.	325.00
M. Kozuki	519.03
Mrs. Okjima	811.97
Pete Dawson	2,430.00
Ray Stevens	262.78
Mrs. W. J. Welsh	444.40

---

 8,234.43

---

 142,861.03

## Liabilities

Reserve a/c .....\$ 3,959.02

## Accounts Payable:

Max Arnold	16.95
J. Harkness	20.00
L. Powers	593.45
H. Schwaegler	30.00

---

 660.40

---

 4,619.42

## Capital

F. J. Harkness, Sr.	\$34,560.41
Mrs. M. A. Harkness	34,560.40
Harriet Harkness Colgate	34,560.40
F. J. Harkness, Jr.	34,560.40

---

 \$138,241.61

---

 \$142,861.03



Nos. 12,618 and 12,619

---

**In the United States Court of Appeals  
for the Ninth Circuit**

---

**MOLLY A. HARKNESS, PETITIONER**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

**FLOYD J. HARKNESS, PETITIONER**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

---

**ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX  
COURT OF THE UNITED STATES**

---

**BRIEF FOR THE RESPONDENT**

---

**THERON LAMAR CAUDLE,**

*Assistant Attorney General.*

**ELLIS N. SLACK,**

**LEE A. JACKSON,**

**HARRY BAUM,**

*Special Assistants to the Attorney General.*

---

FILED



# INDEX

	Page
Opinion Below .....	1
Jurisdiction .....	2
Question Presented .....	2
Statute and Regulations Involved .....	2
Statement .....	3
Summary of Argument .....	8

## Argument:

The record fully supports the Tax Court's conclusion that taxpayer's children were not his partners for tax purposes during the taxable year 1943 .....	11
A. The applicable principles .....	13
B. The Tax Court applied the correct principles .....	21
C. The Tax Court's conclusion is amply supported by the record .....	22
1. No new capital .....	23
2. No services .....	24
3. No management participation .....	26
4. No business purpose .....	28
5. Income not distributed to children .....	30
6. Other factors .....	31
Conclusion .....	33
Appendix .....	34

## CITATIONS

### Cases:

<i>Appel v. Smith</i> , 161 F. 2d 121 .....	14
<i>Argo v. Commissioner</i> , 150 F. 2d 67, certiorari denied, 326 U. S. 762 .....	13
<i>Barrett v. Commissioner</i> , decided November 13, 1950 .....	13, 22
<i>Belcher v. Commissioner</i> , 162 F. 2d 974, certiorari denied, 332 U. S. 824 .....	13
<i>Benson v. Commissioner</i> , 161 F. 2d 821 .....	13
<i>Blalock v. Allen</i> , 151 F. 2d 927 .....	13
<i>Bradshaw v. Commissioner</i> , 150 F. 2d 918 .....	14
<i>Camfield v. Commissioner</i> , 154 F. 2d 1016 .....	14
<i>Collamer v. Commissioner</i> , decided November 8, 1950 .....	13
<i>Commissioner v. Culbertson</i> , 337 U. S. 733 .....	13
<i>Commissioner v. Sunnen</i> , 333 U. S. 591 .....	13
<i>Commissioner v. Tower</i> , 327 U. S. 280 .....	13
<i>Davis v. Commissioner</i> , 161 F. 2d 361 .....	13
<i>Dawes v. Allen</i> , 157 F. 2d 518 .....	14
<i>Dawson v. Commissioner</i> , 163 F. 2d 664 .....	14
<i>DeKorse v. Commissioner</i> , 158 F. 2d 801 .....	14
<i>Denison v. Commissioner</i> , 180 F. 2d 938 .....	14

Cases—Continued

	Page
<i>Doll v. Commissioner</i> , 149 F. 2d 239, certiorari denied, 326 U. S. 725 .....	14
<i>Earp v. Jones</i> , 131 F. 2d 292, certiorari denied, 318 U. S. 764 ..	14
<i>Economos v. Commissioner</i> , 167 F. 2d 165, certiorari denied, 335 U. S. 826 .....	13, 29
<i>Eisenberg v. Commissioner</i> , 161 F. 2d 506, certiorari denied, 332 U. S. 767 .....	13
<i>Epps v. Commissioner</i> , 164 F. 2d 482 .....	14
<i>Ewing v. Commissioner</i> , 157 F. 2d 679 .....	14
<i>Fletcher v. Commissioner</i> , 164 F. 2d 182, certiorari denied, 333 U. S. 855 .....	13
<i>Grant v. Commissioner</i> , 150 F. 2d 915 .....	14
<i>Greenberg v. Commissioner</i> , 158 F. 2d 800 .....	14
<i>Greenberger v. Commissioner</i> , 177 F. 2d 990 .....	33
<i>Hash v. Commissioner</i> , 152 F. 2d 722, certiorari denied, 328 U. S. 838 .....	13, 29
<i>Helvering v. Clifford</i> , 309 U. S. 331 .....	30
<i>Houghland v. Commissioner</i> , 166 F. 2d 815, certiorari denied, 334 U. S. 846 .....	14
<i>Kohl v. Commissioner</i> , 170 F. 2d 531, certiorari denied, 337 U. S. 956 .....	14
<i>Livie v. Commissioner</i> , 155 F. 2d 728 .....	14
<i>Lorenz v. Commissioner</i> , 148 F. 2d 527, certiorari denied, 327 U. S. 786 .....	14
<i>Losh v. Commissioner</i> , 145 F. 2d 456 .....	14
<i>Lowry v. Commissioner</i> , 154 F. 2d 448, certiorari denied, 329 U. S. 725 .....	14
<i>Lucas v. Earl</i> , 281 U. S. 111 .....	30
<i>Lusthaus v. Commissioner</i> , 149 F. 2d 232 .....	13
<i>Lusthaus v. Commissioner</i> , 327 U. S. 293 .....	13
<i>Mauldin v. Commissioner</i> , 155 F. 2d 666 .....	13, 30
<i>MacDonald v. Commissioner</i> , 165 F. 2d 213 .....	14
<i>Mead v. Commissioner</i> , 131 F. 2d 323, certiorari denied, 318 U. S. 777 .....	13
<i>Moore v. Commissioner</i> , 170 F. 2d 191, certiorari denied, 337 U. S. 956 .....	13
<i>Morano v. Commissioner</i> , 175 F. 2d 555, certiorari denied, 338 U. S. 904 .....	13
<i>Morrison v. Commissioner</i> , 177 F. 2d 351 .....	13
<i>Morton v. Thomas</i> , 158 F. 2d 574, certiorari denied, 330 U. S. 834 .....	13
<i>Nelsen v. Commissioner</i> , 177 F. 2d 203 .....	14
<i>Nordling v. Commissioner</i> , 166 F. 2d 703, certiorari denied, 335 U. S. 817 .....	13, 14
<i>Quon v. Commissioner</i> , 165 F. 2d 215, certiorari denied, 334 U. S. 845 .....	13
<i>Ritter v. Commissioner</i> , 174 F. 2d 377, rehearing denied, July 6, 1949 .....	13, 19
<i>Schaeffer v. Commissioner</i> , 174 F. 2d 827 .....	13



Cases—Continued

	Page
<i>Scherf v. Commissioner</i> , 161 F. 2d 495, certiorari denied, 332 U. S. 810 .....	13, 20
<i>Schreiber v. Commissioner</i> , 160 F. 2d 108 .....	14
<i>Sewell v. Commissioner</i> , 151 F. 2d 765, certiorari denied, 327 U. S. 783 .....	13
<i>Sewell's Estate v. Commissioner</i> , 151 F. 2d 806, certiorari denied, 327 U. S. 805 .....	13
<i>Stanback v. Robertson</i> , 183 F. 2d 889 .....	13
<i>Supornick v. Commissioner</i> , 150 F. 2d 110 .....	14
<i>Sweigard v. Commissioner</i> , 149 F. 2d 646 .....	13
<i>Thorrez v. Commissioner</i> , 155 F. 2d 791 .....	14
<i>Tinkoff v. Commissioner</i> , 120 F. 2d 564 .....	14, 28, 33
<i>Trapp v. United States</i> , 177 F. 2d 1 .....	14
<i>Tyson v. Commissioner</i> , 146 F. 2d 50 .....	14
<i>Wilson v. Commissioner</i> , 161 F. 2d 556, certiorari denied, 332 U. S. 769 .....	13

Statute:

Internal Revenue Code:

Sec. 11 (26 U.S.C. 1946 ed., Sec. 11) .....	34
Sec. 22 (26 U.S.C. 1946 ed., Sec. 22) .....	34
Sec. 181 (26 U.S.C. 1946 ed., Sec. 181) .....	34
Sec. 182 (26 U.S.C. 1946 ed., Sec. 182) .....	32
Sec. 3797 (26 U.S.C. 1946 ed., Sec. 3797) .....	35

Miscellaneous:

H. Conference Rep. No. 3124, 81st Cong., 2d Sess., pp. 1, 31 ..	21
Revenue Bill of 1950 (H.R. 8920, 81st Cong., 2d Sess.), Sec. 222 .....	20
Treasury Regulations 111, Sec. 29.22(a)-1 .....	35



**In the United States Court of Appeals  
for the Ninth Circuit**

---

No. 12,618

MOLLY A. HARKNESS, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

No. 12,619

FLOYD J. HARKNESS, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

---

*ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX  
COURT OF THE UNITED STATES*

---

**BRIEF FOR THE RESPONDENT**

---

**OPINION BELOW**

The opinion of the Tax Court (R. 250-281)<sup>1</sup> is reported at 13 T.C. 1039.

---

<sup>1</sup> References designated "R" are to the record in No. 12,618, while references designated "RR" are to the record in No. 12,619. The petitioners are a husband and wife who filed their returns on the community property basis. The cases present a common question, and were consolidated for hearing and opinion below. (R. 250.) By stipulation of the parties approved by this Court, the appeals have also been consolidated for purposes of briefing, argument and opinion. (R. 316-317; RR. 47.)

## JURISDICTION

These petitions for review (R. 285-303; RR. 16-34) involve federal income and victory taxes for the year 1943. The Commissioner's notices of deficiency were mailed to the taxpayers on August 21, 1947. (R. 9, RR. 12.) Within ninety days thereafter, and on November 10, 1947, taxpayers filed petitions with the Tax Court for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code. (R. 28, RR. 9.) The decisions of the Tax Court sustaining the deficiencies were entered February 15, 1950. (R. 284, RR. 15.) The cases are brought to this Court by petitions for review filed May 12, 1950 (R. 304, RR. 35), pursuant to the provisions of Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948. The cases were consolidated for hearing before the Tax Court (R. 250) and have been consolidated for briefing, hearing, and opinion by this Court. (R. 316-317, RR. 47).

## QUESTION PRESENTED

Whether the record warrants the Tax Court's conclusion that taxpayers' children were not their partners for federal income tax purposes during the taxable year 1943, and hence that the shares of the 1943 business income attributed to the children were includible in taxpayers' gross incomes as defined in Section 22(a) of the Internal Revenue Code.

## STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.



## STATEMENT

The facts as stipulated (R. 30-36) and found by the Tax Court (R. 250-273) may be summarized as follows:

Taxpayers, husband and wife, are residents of California and filed their income tax returns on the community property basis. They have a son who was twenty-five years old in 1943, the taxable year here involved, and a daughter who was then twenty-three years old. From 1937 until the end of 1942, the taxpayer, Floyd J. Harkness,<sup>2</sup> carried on, as sole proprietor, the business of growing and shipping fruits under the name of United Packing Company. The main office of the business was at Fresno, California, but its operations covered a large area in the San Joaquin Valley. The net income of the business for 1942 and 1943 amounted to \$141,790 and \$361,582, respectively. (R. 250-251, 271-272.)

The son graduated from college in June of 1941. From 1934 until his graduation he had worked in his father's business during summer vacations, and in 1937 he quit school for six months to help his father. For about six months after his graduation he was a full-time employee at a salary of \$150 per month plus a bonus of about \$910. In January of 1942 he entered the Air Corps, where he remained until 1946, and at the close of 1942 he still had a salary credit on the books of the business of \$1,412.05. He owned no substantial property outside of these earnings. (R. 252, 270-271.)

---

<sup>2</sup> The term "taxpayer," whenever appearing herein, has reference to petitioner Floyd J. Harkness. His wife is a petitioner only because the returns were filed on a community property basis.

The daughter graduated from college in June of 1942. During summer vacations she had occasionally performed secretarial services for her father. Shortly after her graduation she married one Colgate, who was then serving in the Army, and from then until October of 1944 she spent her time housekeeping for her husband at various military posts. Throughout the taxable year (1943) she and her husband were stationed at Columbus, Ohio. She owned no significant amount of property. (R. 252-253.)

In the fall of 1942 taxpayer decided to convert his business from a sole proprietorship to a partnership composed of his wife, son and daughter. The primary reason was to obtain the future services of his son and son-in-law. He was well aware that neither would be available for the duration of the war, and that he would be the only active partner in the meantime, but he hoped to obtain their services after they left the Army. He also felt that if he made his children partners they would be willing to leave their share of the profits in the business. Tax saving was only a secondary consideration in his decision to form the partnership. (R. 253-256, 275-276.)

In November of 1942 a certificate of co-partnership was executed by taxpayer, his wife, and their son and daughter, and the certificate was filed with the county recorder. It stated that the four were partners carrying on business under the name of United Packing Company, and that taxpayer was the general manager in full charge of all business operations. On December 31, 1942, a partnership agreement was drafted and on the following day taxpayer and his wife transferred to the

partnership most of the assets and some of the liabilities of the business theretofore carried on by taxpayer as sole proprietor, resulting in a net worth of \$138,241.61 for the partnership on that date. The two children each bought a one-fourth interest in the business for \$34,560.41 (equivalent to one-fourth of the net worth) in exchange for their unsecured promissory notes to taxpayer. The son used \$1,392.05 of the credit he had earned as compensation for prior services to reduce his note. These transactions were reflected on the books of the business. A few days later, pending the execution of a formal partnership agreement, the parties signed a supplemental agreement which provided that taxpayer was to receive a salary of 75 per cent of the first \$100,000 of the business net income as general manager of the partnership, and that the remaining profits were to be divided equally among the partners. The agreement stated that this division was agreed upon "on account of the fact that he [taxpayer] is the only active co-partner in said business at this particular time and will continue as such during the duration of the present war." (R. 256-259.) A formal partnership agreement, dated as of December 31, 1942, was signed by the parties in March of 1943. Its execution was delayed because objections to certain provisions in the original draft had been raised by the daughter. (R. 257-259.)

The partnership agreement provided, among other things, that taxpayer and his wife "sell, convey and set over, an undivided one-fourth partnership interest" to each of their children, the "purchase price" to consist of a promissory note from each child to taxpayer equal



to one-fourth of the net worth of the business. Taxpayer was to be "the general manager \* \* \* in full charge of all business operations", with "the full right to conduct the business of said co-partnership in such manner as he may desire." In consideration of his services taxpayer was to receive a percentage of the net profits to be agreed upon by the parties, the balance of the profits to be divided equally. Any profits to which the children became entitled were to be applied first in payment of the promissory notes given by them to taxpayer as the purchase price of their partnership interests. Taxpayer was to use "his own good judgment and best efforts and experience in carrying on said business for the best interests of all parties", while the other partners "shall not devote any time or attention in carrying on said business unless hereafter agreed upon." Taxpayer was to "have complete charge" of the books and records, and "full charge of the collections and expenditures" of the business. Moreover, "all of the business transactions of [taxpayer] \* \* \* in carrying on said business shall be binding on all of the said co-partners." Taxpayer was to render on the first of each year a full accounting of profits or losses. In case of any misunderstanding regarding taxpayer's conduct of the business, the decision of taxpayer and one other partner was to be binding, and if dissatisfied the other partners could bring proceedings to dissolve the partnership. (R. 259-269.)

The formation of the partnership produced no change in the conduct of the business during the taxable year 1943. The business remained, as before, completely under taxpayer's control. The daughter performed no



services, nor did she participate in the management of the business during 1943; she and her husband lived at Columbus, Ohio, throughout that year and until October, 1944. The son was stationed at Hamilton Field, California, throughout 1943, and frequently visited the company's office on week-ends. He was unable to participate in the business, but on these visits discussed its problems with taxpayer. He went overseas in December of 1943 and did not return until 1946. (R. 30-31, 252-253, 270-271.)

The net income of the business for 1943 amounted to \$361,582. In accordance with the agreement taxpayer received the first \$75,000 as salary, and the remaining profits were credited on the books to the four partners in equal shares of \$71,645.50 each. The shares credited to the son and daughter were first applied in payment of the notes they had given to taxpayer for their partnership interests. The balance of the daughter's share was used to pay taxes and for personal expenditures. The balance of the son's share (except for \$331 withdrawn in 1944) was left in the business and added to his capital account. (Ex. 6-F to Stip., R. 61, 65; R. 271.)

A partnership return was filed for the year 1943 in which \$75,000 of the net income of the business was reported as compensation paid to taxpayer, and the balance as distributable to the four partners in equal one-fourth shares of \$71,645.50 each. Taxpayer and his wife filed separate individual income tax returns on the community property basis, each reporting one-half of the total income they together received, or \$109,145.50 each. The Commissioner determined that

the children were not partners for federal income tax purposes and that the total net income of the business for 1943 was taxable to taxpayer and his wife on a community property basis, and computed deficiencies accordingly. (R. 271-273.) The Tax Court, on the basis of all the evidence, found that the parties had no intention to join together in conducting the business as partners in 1943, and sustained the Commissioner's determination. (R. 273-280.)

#### SUMMARY OF ARGUMENT

In concluding that taxpayer's children were not partners for tax purposes during the taxable year 1943, the Tax Court followed the principles prescribed by the Supreme Court in the *Tower*, *Lusthaus*, and *Culbertson* cases, and applied by this and other Courts in a multitude of other family partnership cases. The issue is who earned the business income during the taxable year, and that depends on whether taxpayer and his children really intended to and did join together in carrying on the business as partners in that year. Unless the arrangement produces a substantial change in the management and conduct of the business, it is without economic reality and amounts in substance to but a reallocation of the business income without any change in its creation. It is also settled that whether the claimed partnership has economic reality presents a question of fact in each case, no single factor being conclusive, and that the Tax Court's determination should not be disturbed unless clearly erroneous. While no single factor is decisive, nevertheless (as held in *Culbertson*) lack of a contribution of new capital or of vital addi-

tional services or of a change in management places a heavy burden of proof on the taxpayer. Where the claimed partnership is predicated upon a gift of a portion of the taxpayer's business capital to a member of his family, or as here on a "sale" of some of the capital in exchange for notes payable out of the business profits, the transferee does not become the true owner of the transferred capital, and hence a true partner for tax purposes, unless he exercises control over the capital by participating in the management of the business. That the transferee participates in management of the business or contributes vital services to the business in a later year does not suffice to make him a partner during the taxable year.

As is plain from its opinion, the Tax Court applied these established principles. On the basis of all the evidence, including the agreement and conduct of the parties, it concluded that taxpayer and his children did not really intend to join together in carrying on the business as partners during 1943. Far from being erroneous, as taxpayer contends, this conclusion is amply supported by the record. The formation of the partnership was based upon (1) a sale by taxpayer to his children of portions of the capital already invested in the business by him, in exchange for the children's notes payable out of the shares of the profits ascribed to them as partners; and (2) the expectation that one of the children (the son) would participate in management and contribute vital services in future years, after his discharge from the Army. The sale and contemporaneous admission of the children as partners produced no change in the conduct of the business and the earn-



ing of its income during the taxable year. The business was conducted and its income was earned by taxpayer during that year in the same way as before, when he was the sole proprietor. The only difference was that portions of the income were allocated to the children. The agreement served no business purpose during the taxable year, since nothing was added to the business by way of capital or services or management. Cumulative support for the Tax Court's conclusion is furnished by the fact that the shares of the 1943 profits attributed to the children as partners were not distributed to them, but were applied in payment of their notes to taxpayer and retained in the business.

Taxpayer's elaborate argument reduces itself simply to the contention that the sale of some of his capital to his son and daughter, with the expectation of the son's participation in the business in years subsequent to the taxable year, suffices *per se* to render both children partners for tax purposes during the taxable year here involved. The contention runs counter to the Supreme Court's holding in the *Lusthaus* case, and indeed is substantially the same argument as was advanced by the taxpayer and rejected by the Supreme Court in the *Culbertson* case. Even assuming the argument were sound as to the son, it has no applicability as to the daughter who did not participate in the business even in later years. This case is essentially no different from the numerous family partnership cases in which an intra-family sale or gift of a portion of the taxpayer's capital has been held ineffectual to render the transferee his partner for tax purposes. To hold that the Tax Court was obliged to accord tax effect to the in-



stant arrangement would sanction the very type of formalism repeatedly condemned by the Supreme Court and by this and other Courts in like cases.

#### ARGUMENT

### **The Record Fully Supports the Tax Court's Conclusion That Taxpayer's Children Were Not His Partners for Tax Purposes During the Taxable Year 1943**

The sole question presented is whether taxpayer's son and daughter were his partners for federal income tax purposes during the taxable year 1943. The material evidentiary facts are not in dispute. Prior to 1943 taxpayer carried on, as sole proprietor, a fruit packing business in southern California. At the end of 1942 he (and his wife, who owned the business assets in community with him) transferred a one-fourth interest in the business assets to each child, in exchange for promissory notes of the children payable out of the business profits, and contemporaneously entered into a partnership agreement with the children. (R. 251-262.) The agreement provided that taxpayer was to be the "general manager" of the business, "in full charge of all business operations", with the "full right to conduct the business of said co-partnership in such manner as he may desire." (R. 262-263.) The arrangement produced no change in the control and conduct of the business during the taxable year. Taxpayer continued, as before, to manage and carry on its affairs. The children contributed no new capital, did not participate in management, and performed no services during the taxable year. (R. 270-271, 274-280.) The son graduated from college in 1941, worked as a sal-

aried employee of taxpayer for the next six months, joined the Air Force at the beginning of 1942, and throughout the taxable year 1943 continued to serve in the Air Force. The daughter graduated from college in 1942, married shortly thereafter, and throughout the taxable year lived with her husband in Ohio. (R. 30-31, 252-253, 270-271.) On the basis of the entire record, the Tax Court concluded that (R. 274-275, 280):

we are convinced that there was no intent on the part of the four alleged partners to join together in the present conduct of United Packing Co. in 1943.

\* \* \* \* \*

On the basis of all the evidence we believe that the three Harknesses and Harriet Colgate had no present intent but rather an indefinite future plan to operate United Packing Co. as a genuine partnership when the partnership papers were drawn up and thus we conclude and found as a fact that the Harkness children were not bona fide partners in 1943 within the meaning of *Commissioner v. Culbertson, supra*.

We submit that the Tax Court applied the correct principles, and that its conclusion is fully supported by the record. This case is essentially no different from numerous other family partnership cases in which a gift or sale of some of the taxpayer's business capital has been held ineffectual to render the transferee a real partner for tax purposes.

### A. The applicable principles.

The controlling principles were enunciated in *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293, were reaffirmed in *Commissioner v. Culbertson*, 337 U. S. 733, and have been applied by this Court<sup>3</sup> and other courts<sup>4</sup> in a legion of family partnership cases. "The issue is who earned the income and that issue depends on whether this husband and wife [here a father and children] really intended to carry on business as a partnership." *Commissioner v. Tower*, *supra*, p. 289. As stated in the *Culbertson* case (p. 742), the test is "whether, considering all the facts \* \* \* the parties in good

---

<sup>3</sup> *Nordling v. Commissioner*, 166 F. 2d 703, certiorari denied, 335 U.S. 817; *Quon v. Commissioner*, 165 F. 2d 215 (affirming *per curiam* 6 T.C.M. 348), certiorari denied, 334 U.S. 845.

<sup>4</sup> See e.g., First Circuit: *Barrett v. Commissioner*, decided November 13, 1950 (1950 C.C.H., par. 9501); Second Circuit: *Morrison v. Commissioner*, 177 F. 2d 351; *Fletcher v. Commissioner*, 164 F. 2d 182, certiorari denied, 333 U.S. 855. Third Circuit: *Morano v. Commissioner*, 175 F. 2d 555, certiorari denied, 338 U.S. 904; *Eisenberg v. Commissioner*, 161 F. 2d 506, certiorari denied, 332 U.S. 767; *Schaeffer v. Commissioner*, 174 F. 2d 827; *Davis v. Commissioner*, 161 F. 2d 361; *Lusthaus v. Commissioner*, 149 F. 2d 232, affirmed, 327 U.S. 293; *Sweigard v. Commissioner*, 149 F. 2d 646. Fourth Circuit: *Ritter v. Commissioner*, 174 F. 2d 377, rehearing denied July 6, 1949; *Moore v. Commissioner*, 170 F. 2d 191, certiorari denied, 337 U.S. 956; *Economos v. Commissioner*, 167 F. 2d 165, certiorari denied, 335 U.S. 826; *Wilson v. Commissioner*, 161 F. 2d 556, certiorari denied, 332 U.S. 769; *Mauldin v. Commissioner*, 155 F. 2d 666; *Hash v. Commissioner*, 152 F. 2d 722, certiorari denied, 328 U.S. 838; *Stanback v. Robertson*, 183 F. 2d 889; *Collamer v. Commissioner*, decided November 8, 1950 (1950 C.C.H., par. 9498). Fifth Circuit: *Scherf v. Commissioner*, 161 F. 2d 495, certiorari denied, 332 U.S. 810; *Benson v. Commissioner*, 161 F. 2d 821; *Belcher v. Commissioner*, 162 F. 2d 974, certiorari denied, 332 U.S. 824; *Mead v. Commissioner*, 131 F. 2d 323, certiorari denied, 318 U.S. 777; *Argo v. Commissioner*, 150 F. 2d 67, certiorari denied, 326 U.S. 762; *Sewell's Estate v. Commissioner*, 151 F. 2d 806, certiorari denied, 327 U.S. 805; *Sewell v. Commissioner*, 151 F. 2d 765, certiorari denied, 327 U.S. 783; *Dawes v. Allen*, 157 F. 2d 518; *Blalock v. Allen*, 151 F. 2d 927; *Morton v. Thomas*, 158



faith and acting with a business purpose intended to join together in the present conduct of the enterprise.” Whether the claimed partnership meets that test presents a question of ultimate fact in each case. *Nordling v. Commissioner*, 166 F. 2d 703 (C. A. 9th), certiorari denied, 335 U. S. 817. While no single factor is conclusive, nevertheless (*Commissioner v. Culbertson*, *supra*, p. 744):

Unquestionably a court’s determination that the services contributed by a partner are not “vital” and that he has not participated in “management and control of the business” or contributed “original capital” has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners.

In the *Tower* case a valid and irrevocable gift by a husband to his wife of a portion of his business capital was held ineffectual to render the wife a partner for tax

---

F. 2d 574, certiorari denied, 330 U.S. 834. Sixth Circuit: *Denison v. Commissioner*, 180 F. 2d 938; *Nelson v. Commissioner*, 177 F. 2d 203; *Houghland v. Commissioner*, 166 F. 2d 815, certiorari denied, 334 U.S. 846; *Dawson v. Commissioner*, 163 F. 2d 664; *Lourey v. Commissioner*, 154 F. 2d 448, certiorari denied, 329 U.S. 725; *Lorenz v. Commissioner*, 148 F. 2d 527, certiorari denied, 327 U.S. 786; *Thorrez v. Commissioner*, 155 F. 2d 791; *Camfield v. Commissioner*, 154 F. 2d 1016; *Livie v. Commissioner*, 155 F. 2d 728; *Ewing v. Commissioner*, 157 F. 2d 679; *DeKorse v. Commissioner*, 158 F. 2d 801; *Greenberg v. Commissioner*, 158 F. 2d 800; *Schreiber v. Commissioner*, 160 F. 2d 108; *MacDonald v. Commissioner*, 165 F. 2d 213; *Epps v. Commissioner*, 164 F. 2d 482. Seventh Circuit: *Appel v. Smith*, 161 F. 2d 121; *Tinkoff v. Commissioner*, 120 F. 2d 564. Eighth Circuit: *Kohl v. Commissioner*, 170 F. 2d 531, certiorari denied, 337 U.S. 956; *Doll v. Commissioner*, 149 F. 2d 239, certiorari denied, 326 U.S. 725; *Supornick v. Commissioner*, 150 F. 2d 110; *Tyson v. Commissioner*, 146 F. 2d 50. Tenth Circuit: *Trapp v. United States*, 177 F. 2d 1; *Earp v. Jones*, 131 F. 2d 292, certiorari denied, 318 U.S. 764; *Grant v. Commissioner*, 150 F. 2d 915; *Bradshaw v. Commissioner*, 150 F. 2d 918; *Losh v. Commissioner*, 145 F. 2d 456.



purposes, where she neither participated in management nor contributed services. The Supreme Court held (p. 292) that the record furnished "more than ample evidence to support the Tax Court's finding that no genuine union for partnership business purposes was ever intended and that the husband earned the income." In the *Lusthaus* case it held that a valid sale by a husband to his wife of a portion of his capital did not suffice to make the wife a partner in the tax sense, notwithstanding that she also rendered services, and it approved the Tax Court's determination that (p. 297) "the partnership arrangements were merely superficial, and did not result in changing the husband's economic interest in the business." In the *Culbertson* case, involving a claimed father-sons partnership, the Supreme Court reversed the Court of Appeals (which had reversed the Tax Court's refusal to recognize the partnership), and remanded the case to the Tax Court (p. 748)<sup>5</sup>—

\* \* \* for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of

---

<sup>5</sup> In the *Culbertson* case the Tax Court had considered only "original capital" and "vital services" in testing the reality of the partnership. The Supreme Court held (p. 744, fn. 14) that the Tax Court should have considered "management and control," a factor equally emphasized by it in the *Tower* case. It stated (p. 747) that "If the donee of property who then invests it in the family partnership exercises dominion and control over that property" he "may" become its true owner, and hence a true partner, for tax purposes.

capital of which they were the true owners, as we have defined that term in the *Clifford, Horst* and *Tower* cases?

The rationale of the Supreme Court's decisions in *Tower, Lusthaus*, and *Culbertson*, is that the Tax Court is not obliged to accord tax effect to a legally perfect family partnership arrangement which produces no substantial change in the creation of the business income, but merely a reallocation of it within the family. "The statutes of Congress designed to tax income actually earned because of the capital and efforts of each individual member of a joint enterprise are not to be frustrated by state laws which for state purposes prescribe the relations of the members to each other and to outsiders." *Commissioner v. Tower, supra*, p. 288; see also *Commissioner v. Culbertson, supra*, pp. 739-740.

In reiterating the principles enunciated by it in the *Tower* case, the Supreme Court in *Culbertson* stated (pp. 739-740):

In the *Tower* case we held that despite the claimed partnership, the evidence fully justified the Tax Court's holding that the husband, through his ownership of the capital and his management of the business, actually created the right to receive and enjoy the benefit of the income and was thus taxable upon that entire income under §§ 11 and 22(a). In such case, other members of the partnership cannot be considered "Individuals carrying on business in partnership" and thus "liable for income tax . . . in their individual capacity" within the meaning of § 181. If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years

in question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years. The partnership sections of the Code are, of course, geared to the sections relating to taxation of individual income, since no tax is imposed upon partnership income as such. To hold that "Individuals carrying on business in partnership" include persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it.

Furthermore, the Supreme Court in *Culbertson* made it clear (pp. 738-740) that a donee or vendee of a portion of the business capital does not become a partner during the taxable year merely because it is intended that he will contribute vital services or participate in management in a future year. In that case the taxpayer in 1939 sold interests in his ranching business to his four sons in exchange for their notes. All of the sons had performed services on the ranch since they were youngsters. During the taxable years (1940-1941) the eldest son continued, as before, to serve as foreman of the ranch. The second son finished college in 1940, went directly into the Army, and remained there during the taxable years. The two younger sons were still attending school, but worked on the ranch during summers and week-ends. The Tax Court refused to recognize any of the sons as partners for tax purposes. The Court of Appeals reversed on the ground that the sale of portions of the taxpayer's capital to the sons, made with the good faith expectation of the sons' future serv-



ices, required recognition of the sons' claimed partnership status. In reversing the Court of Appeals and remanding the case to the Tax Court,<sup>6</sup> the Supreme Court stressed that the basic question is who earned the income during the taxable year, not who expects to earn it in future years. It stated (pp. 738-740):

The Court of Appeals, on the other hand, was of the opinion that a family partnership entered into without thought of tax avoidance should be given recognition taxwise whether or not it was intended that some of the partners contribute either capital or services during the tax year and whether or not they actually made such contributions, since it was formed "with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership." We must consider, therefore, whether an intention to contribute capital or services sometime in the future is sufficient to satisfy ordinary concepts of partnership, as required by the *Tower* case. \* \* \*

\* \* \* \* \*

Furthermore, our decision in *Commissioner v. Tower, supra*, clearly indicates the importance of participation in the business by the partners during the tax year. We there said that a partnership is created "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and where there is community of interest in the profits and losses." This is, after all, but the application of an often

---

<sup>6</sup> Upon the remand the Tax Court took additional evidence and, applying the principles expressed by the Supreme Court, held that none of the sons were partners for tax purposes during the taxable years. (9 T.C.M. 647.)



iterated definition of income—the gain derived from capital, from labor, or from both combined—to a particular form of business organization. A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services. *Ward v. Thompson*, 22 How. 330, 334 (1859). The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of §§ 11 and 22(a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. *The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.* (Italics ours.)

In *Ritter v. Commissioner*, 174 F. 2d 377 (C.A. 4th), the taxpayer had agreed to make his son a partner and, after the son graduated from college, transferred a portion of his business capital to the son and entered into a partnership agreement with him. The son was prevented from immediately participating in the business, because he entered military service shortly after his graduation. In affirming the Tax Court's refusal to recognize the son as a partner for tax purposes, the court stated (p. 378):<sup>7</sup>

But whatever may have been the intention of father and son, and whatever may have been in their contemplation as to the future, it is crystal clear that neither thought (when the partnership

---

<sup>7</sup> In the *Ritter* case the Fourth Circuit Court of Appeals extended taxpayer's time to petition for rehearing because of the pendency of the *Culbertson* case; the petition, based on the Supreme Court's *Culbertson* decision, was denied July 6, 1949.

agreement was signed) that the son would contribute anything to the partnership, either capital or services, during the tax year 1943, and that is what concerns us here.

See also *Scherf v. Commissioner*, 161 F. 2d 495, 498 (C.A. 5th), certiorari denied, 332 U. S. 810.

To be sure, in the *Culbertson* case (pp. 747-748), the Supreme Court indicated that an intra-family gift or sale of business capital may render the transferee the true owner, and hence a true partner for tax purposes, *if* the transferee exercises dominion and control over the transferred property by participating in management and influencing the conduct of the business. But it is clear from the Supreme Court's holdings in *Tower*, *Lusthaus* and *Culbertson* that neither the transfer, nor anticipated future services of the transferee, nor a combination of these features, compels the conclusion that the transferee is the true owner of the property and a true partner. That Congress never intended to recognize, for tax purposes, a family partnership erected upon an intra-family gift or sale of business capital is confirmed by the fact that amendments proposed by the Senate Finance Committee to the Revenue Bill of 1950 (H.R. 8920, 81st Cong., 2d Sess.), designed to accord partnership status to donees or vendees of partnership interests, were deleted from the Bill by the Conference Committee and never became a part of the Revenue Act of 1950.<sup>8</sup>

---

<sup>8</sup> Section 222(a) of the Bill, added by the Senate Finance Committee (Amendment No. 110), would have amended Code Section 3797(a)(2), Appendix, *infra*, by adding the following:

A person shall be recognized as a partner for income-tax purposes if he owns a capital interest in a partnership in which

Taxpayer's elaborate argument misconceives the plain tenor of the Supreme Court's holdings in the *Tower*, *Lusthaus* and *Culbertson* cases. Stripped to its essentials, his argument reduces itself to the contention, flatly rejected in the *Culbertson* case, that the Tax Court was obliged to conclude that both his children were partners during the taxable year merely because he sold portions of his capital to each with the expectation that one of them (his son) would contribute services in future years. Even if the argument were otherwise sound, it would have no relevancy as to the daughter.

*B. The Tax Court applied the correct principles.*

As is plain from its opinion, the Tax Court applied the principles enunciated in *Tower*, *Lusthaus*, and *Culbertson*. It did not, as taxpayer asserts (Br. 39-41), ignore the "reality test" prescribed in those cases. On the contrary, that is precisely the test it did apply. Quoting from the Supreme Court's opinion (p. 742),

---

capital is a material income producing factor, whether or not such interest is derived by purchase or gift from any other person.

Section 222(b) of the Bill would have added to the Code a new Section 191 so as to provide *inter alia*, that in the case of a "family partnership"—

The fact that a partner does not actively participate in the management or conduct of the partnership business shall be taken into account in determining the proportionate value of services and capital, but shall not otherwise affect his status as a partner. For the purpose of this action, the term "family partnership" shall mean any partnership as defined in section 3797(a)(2) which includes two or more members of the same family as defined in section 24(b)(2)(D), and for this purpose a trust for the benefit of a member of a family shall be considered a member of such family.

These proposed amendments were stricken out by the Conference Committee. H. Conference Rep. No. 3124, 81st Cong., 2d Sess., pp. 1, 31.



the Tax Court addressed itself (R. 274) to the crucial question of “whether, considering all the facts \* \* \* the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.” After carefully analyzing all the evidence, including the agreement and conduct of the parties and the testimony, it answered that question in the negative. (R. 274-280.)

Since the question presented is one of fact, no single factor being conclusive, the Tax Court’s determination should not be disturbed unless clearly erroneous. *Commissioner v. Culbertson*, *supra*; *Nordling v. Commissioner*, *supra*; *Barrett v. Commissioner* (C.A. 1st), decided November 13, 1950 (1950 C.C.H., par. 9501); *Morrison v. Commissioner*, 177 F. 2d 351 (C.A. 2d); *Morano v. Commissioner*, 175 F. 2d 555 (C.A. 3d), certiorari denied, 338 U. S. 904; *Eisenberg v. Commissioner*, 161 F. 2d 506 (C.A. 3d), certiorari denied, 332 U. S. 767; *Ritter v. Commissioner*, *supra*; *Scherf v. Commissioner*, *supra*; *Denison v. Commissioner*, 180 F. 2d 938 (C.A. 6th); *Appel v. Smith*, 161 F. 2d 121 (C.A. 7th); *Kohl v. Commissioner*, 170 F. 2d 531 (C.A. 8th), certiorari denied, 337 U. S. 956. “Whether the evidence would have supported a different finding by the Tax Court is a question not here presented.” *Commissioner v. Tower*, *supra*, p. 280.

C. *The Tax Court’s conclusion is amply supported by the record.*

The Tax Court’s determination is clearly warranted by the record, especially in the light of the Supreme Court’s admonition (*Commissioner v. Culbertson*,



*supra*, p. 744) that the absence of a contribution of new capital or of vital additional services or of a change in management “has the effect of placing a heavy burden of proof on the taxpayer to show the bona fide intent of the parties to join together as partners”.

1. *No new capital.* Admittedly, no new capital was brought into the business by the admission of taxpayer's children as partners. What they proposed to invest as “partners” was but a part of the capital already invested in the business by taxpayer. In the words of the Supreme Court in the *Tower* case (p. 291), “No capital not available for use in the business before was brought into the business as a result of the formation of the partnership.” The claimed partnership status of the children rests upon nothing more than taxpayer's “sale” to them of some of his capital, in exchange for notes secured by the very partnership interests sold to them and payable out of the shares of the profits attributed to them as partners. Insofar as the claimed capital contribution of the children is concerned, the instant case bears a striking resemblance to the *Lusthaus* case, where a husband sold a one-half interest in his capital to his wife in exchange for her promissory note payable out of the profits distributable to her as a partner. Indeed, the evidentiary support for the Tax Court's conclusion in this case is even stronger than in the *Lusthaus* case. There the vendee-wife also performed services during the taxable year, whereas here neither of the vendee-children did so. Moreover, there the wife had a substantial estate of her own which might have been subject to partnership debts, whereas here (R. 252-253)

the children had no separate property of their own. See also *Nordling v. Commissioner, supra*; *Houghland v. Commissioner, supra*; *Appel v. Smith, supra*.

There is no merit to taxpayer's contention (Br. 41-46, 50-51) that his sale of portions of his capital to the children, in exchange for notes payable out of the business profits, automatically made the children "true owners" of the transferred capital. The sale produced a shift of legal title from taxpayer to the children, not of economic ownership. The vendee-children no more became the real owners of the transferred capital than did the vendee-wife in the *Lusthaus* case, who acquired her interest in the same fashion as did taxpayer's children. To insist, as does taxpayer, that the children must be deemed partners for tax purposes by virtue of their purchase of some of his capital is to make the tax consequences turn on legal formalities rather than economic realities, and to adopt criteria of tax liability which are the very antithesis of those laid down in *Tower*, *Lusthaus* and *Culbertson*.

2. *No services.* Admittedly, the children contributed no services to the business during the taxable year, for they were absent from the business throughout that year. (Stip., R. 30-31.) The partnership agreement itself provided that taxpayer was to have "full charge of all business operations" (R. 262-263), and that the children "shall not devote any time or attention in carrying on said business unless hereafter agreed upon" (R. 264). At most, as the Tax Court pointed out (R. 275-276) and the facts recited by taxpayer show (Br. 18-20), the parties contemplated that taxpayer's son

and son-in-law would participate in the business in *future years*. This of course does not suffice to make either the son or the daughter a partner during the taxable year here involved. To establish a real partnership for tax purposes the taxpayer must show "participation in the business by the partners during the tax year. \* \* \* The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income." *Commissioner v. Culbertson*, p. 740. See also *Ritter v. Commissioner*, *supra*; *Scherf v. Commissioner*, *supra*.

Taxpayer completely misconceives the Supreme Court's holding in the *Culbertson* case in contending (Br. 54-58) that the children must be deemed partners during the taxable year 1943 because of events which occurred in subsequent years. As for the son, until June of 1941 he was still attending college, and for the next six months he was a salaried employee. In January of 1942 he entered the Army, and he remained there until 1946. (R. 30-31, 251-252, 270-271.) Granting *arguendo* that one who has already become a partner in the tax sense does not cease to be one if his services to the business are interrupted by the military service, no such situation is here presented. The son's enlistment in the Army while he was a salaried employee, and the expectation of his future participation in the business after his discharge from the Army, did not operate to change his status from that of employee to partner. Substantially the same argument which taxpayer here is advancing with respect to the son was emphatically rejected by the Supreme Court in *Culbertson*. See also



*Ritter v. Commissioner, supra.* In the *Culbertson* case the Court stated (p. 739, fn. 6):

Of course one who has been a bona fide partner does not lose that status when he is called into military or government service, and the Commissioner has not so contended. On the other hand, one hardly becomes a partner in the conventional sense merely because he might have done so had he not been called.

Even assuming (contrary to the holding in *Culbertson*) that the son must be deemed a partner in 1943 by reason of an expectancy of his future services, that scarcely furnishes any basis for taxpayer's insistence that his daughter must also be recognized as a partner. She was admitted in the hope that her husband—not she—would eventually participate in the business. (R. 253-254, 275-276.) The stipulated facts show that the daughter performed no services in 1943 or at any time thereafter. (R. 31.) Accordingly, even if taxpayer's argument were sound as to the son, it has no relevancy as to the daughter.

3. *No management participation.* In *Tower*, and again in *Culbertson* (p. 747), the Supreme Court indicated that a donee or vendee of business capital may become a true partner for tax purposes if he substantially participates in control and management of the business, "and through that control influences the conduct of the partnership." Here again no such situation is presented. The admission of the children as partners in no way influenced the conduct of the business during the taxable year. The business was carried on after



the formation of the partnership in the same way as before. The only difference was that portions of the profits previously distributable to taxpayer were credited to the children. The partnership agreement itself provided that taxpayer (R. 262-263)—

shall be, and is from this date on made the general manager of said co-partnership, and that he shall be in full charge of all business operations of said co-partnership and that he shall have the full right to conduct the business of said co-partnership in such manner as he may desire, \* \* \*

Pursuant to the agreement taxpayer continued to manage and conduct the business in the same manner as when he was its sole proprietor. In fact, neither child was available to participate in the conduct of the business, since the son was away in the Army and the daughter was living in Ohio. (R. 30-31, 251-252, 270-271.) What is more, taxpayer in his testimony acknowledged that he formed the partnership only in the hope of receiving the future services of his son and son-in-law. (R. 275-276.) Under the circumstances, the Tax Court was fully justified in finding (R. 270) that:

During the year 1943 there was no change in the operation of United Packing Co. over prior years. The business was still completely under the control of Harkness, Sr.

Although taxpayer challenges (Br. 58-75) this finding, he points to nothing in the record which in any way detracts from it. He takes the position (Br. 68) that it was "natural and reasonable that the powers of management should be vested in" him, because the children

would be "absent for an indefinite period" and therefore unable to participate in the conduct of the business. That the children were unable to join together with taxpayer in carrying on the business as partners manifestly does not dispense with the requirement that they do so in order to be treated as partners for tax purposes. Nothing in the decisions or elsewhere warrants the assumption that the conditions precedent to tax recognition of a family partnership need not be met if they cannot be met. On taxpayer's theory even a new-born infant would have to be recognized forthwith as his father's "partner" for tax purposes, simply because the father transfers part of his capital to the child with the expectation that the child will some day participate in the business and assume the responsibilities of a partner.<sup>9</sup>

4. *No business purpose.* In *Culbertson* the Supreme Court stated (p. 742) that the ultimate factual question is whether the parties "acting with a business purpose intended to join together in the present conduct of the enterprise." The record fails to disclose any "business purpose" to be served by the admission of the children

---

<sup>9</sup> In the *Culbertson* case the Supreme Court stated (p. 740, fn. 8):

The *reductio ad absurdum* of the theory that children may be partners with their parents before they are capable of being entrusted with the disposition of partnership funds or of contributing substantial services occurred in *Tinkoff v. Commissioner*, 120 F. 2d 564, where a taxpayer made his son a partner in his accounting firm the day the son was born.

See also *Stanback v. Robertson*, *supra*; *Economos v. Commissioner*, *supra*; *Hash v. Commissioner*, *supra*; *Kohl v. Commissioner*, *supra*; *Eisenberg v. Commissioner*, *supra*; *Morano v. Commissioner*, *supra*; *Belcher v. Commissioner*, *supra*; *Dawson v. Commissioner*, *supra*; *Benson v. Commissioner*, *supra*; *Losh v. Commissioner*, *supra*; *Quon v. Commissioner*, *supra*.

as partners insofar as the “present conduct” of the business was concerned. At most, it shows that taxpayer transferred portions of his capital to his son and daughter in the hope that his son and the daughter’s husband would in some future year contribute vital services. This may hardly be viewed as the equivalent of an intention to carry on business in partnership with the son and daughter during the taxable year 1943. *Commissioner v. Culbertson*, *supra*, pp. 738-740. Insofar as the business was concerned, nothing was added in that year. The only effect of the arrangement was to reallocate the business profits among the members of taxpayer’s family.

Furthermore, the Tax Court found (R. 255-256), and it is undisputed, that taxpayer consulted a lawyer and was aware of the tax saving advantages he might gain by creating the partnership. While the tax saving objective was only a “secondary consideration” (R. 256), it is a relevant factor to be considered in determining whether the partnership was real. In any event, even if the arrangement was in no way motivated by tax avoidance objectives, the tax incidence would still flow from the economic substance of the arrangement irrespective of the underlying motives. *Hash v. Commissioner*, 152 F. 2d 722, 724 (C. A. 4th), certiorari denied, 328 U. S. 838; *Economos v. Commissioner*, 167 F. 2d 165, 167 (C. A. 4th), certiorari denied, 335 U. S. 826; *Nordling v. Commissioner*, *supra*, p. 704. Existence of a tax avoidance motive “simply lends further support to the inference” that the claimed partnership is unreal. *Commissioner v. Tower*, *supra*, p. 289.



5. *Income not distributed to children.* Cumulative support for the Tax Court's conclusion, if any were needed, is furnished by the fact that the shares of the profits ascribed to the children as partners were not distributed to them. The son's share was applied first to payment of the note he gave to taxpayer for his partnership interest, and the balance (except for \$331 withdrawn in 1944) was retained in the business and credited to his capital account. (Ex. 6-F to Stip., R. 61; R. 271.) The daughter's share was also used to pay her note to taxpayer, and for taxes, and the small balance was used for personal expenditures. (Ex. 6-F to Stip., R. 65; R. 271.) Thus taxpayer retained the use and control of most of the income (as well as all of the capital) allocated to the children as partners. Even if all of the income attributed to the children had been distributed to them, the Tax Court would not have been bound to recognize them as partners, since the critical inquiry is who earned the income rather than who collects and spends it. See *Mauldin v. Commissioner*, 155 F. 2d 666 (C. A. 4th); *Helvering v. Clifford*, 309 U. S. 331. In short, the situation here is basically no different from any other where taxpayer diverts part of his income to a member of his family; he does not escape the tax whether the income in question is derived from services (*Lucas v. Earl*, 281 U. S. 111), or from property (*Helvering v. Clifford*, *supra*; *Commissioner v. Sunnen*, 333 U. S. 591), or, as here, from a blend of both sources (*Commissioner v. Tower*, *supra*; *Lusthaus v. Commissioner*, *supra*; *Commissioner v. Culbertson*, *supra*).



6. *Other factors.* The unreality of the arrangement is accentuated by a comparison of the value of the capital interests transferred by taxpayer to his children with the amount of profits credited to them as partners. The net worth of the business at the time of their admission as partners was \$138,241, and the one-fourth share transferred to each was worth \$34,560. (R. 258.) The profits allocated to the children for 1943 amounted to \$71,645 each. (R. 271.) Thus within one year after the formation of the partnership, the share of the profits ascribed to each child as a partner amounted to more than 200 per cent of his or her so-called investment in the business, to say nothing of the fact that what the children purported to invest consisted of capital already in the business and that most of the profits allocated to them were left in the business. Moreover, since the children contributed no services whatever, all of the 1943 profits credited to them as partners represented a return upon their so-called investments. Such a partnership arrangement obviously is not one which would have been made by parties dealing at arm's length.

Under the circumstances, taxpayer failed to carry the "heavy burden" which rested upon him (*Commissioner v. Culbertson, supra*, p. 744), and the Tax Court's conclusion cannot be said to be clearly erroneous. Unless legal formalities are to prevail over economic realities, the conclusion is inescapable that the children became partners during 1943 in name and on paper only. The arrangement produced no change in the conduct of the business and the earning of its income, but merely an allocation to the children of a portion

of the business profits. "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided." *Commissioner v. Tower, supra*, p. 291. See also *Commissioner v. Culbertson, supra*. As this Court stated in *Nordling v. Commissioner, supra*, p. 704, which involved a claimed husband-wife partnership, "In tax matters the realities of a transaction, not artificialities, are given effect." To hold that the Tax Court was obliged as a matter of law to accord tax effect to the instant arrangement would sanction the very type of formalism condemned by the Supreme Court in the *Tower*, *Lusthaus* and *Culbertson* cases, and by this and other Courts in a legion of other family partnership cases. See fn. 3 and 4, *supra*.

Even assuming *arguendo* that the children had contributed both original capital and vital services, it still would not follow, as taxpayer supposes, that these factors would be decisive of the intention of the parties to carry on business together as partners. *Commissioner v. Culbertson, supra*; *Morrison v. Commissioner, supra*; *Denison v. Commissioner, supra*. It would constitute but one of many relevant factors to be considered by the Tax Court in determining the real intent, and the Tax Court properly based its conclusion on the record as a whole.

Taxpayer points to no authority which calls for reversal of the decision below. Each case in this field turns, as it must, on its own facts. Although taxpayer relies chiefly upon the *Culbertson* case, it is plain from the opinion below that the Tax Court reached its decision here in the light of the principles enunciated in

that case. Indeed, the Supreme Court's opinion in that case, in and of itself, furnishes a complete refutation to taxpayer's contention that the Tax Court here committed reversible error. The case of *Greenberger v. Commissioner*, 177 F. 2d 990 (C.A. 7th), upon which taxpayer also strongly relies (Br. 49, 72-73), is not comparable on its facts. Compare the decisions of the same court in *Appel v. Smith, supra*, and *Tinkoff v. Commissioner*, 120 F. 2d 564. If any comparison is to be drawn between this and other cases, then we submit that this one bears a closer resemblance to the *Lusthaus* and *Culbertson* cases, and the numerous other family partnership cases (fn's 3 and 4) in which the Courts of Appeals have upheld the Tax Court's refusal to recognize the claimed partnership, than to those which taxpayer cites.

#### CONCLUSION

The decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted,

THERON LAMAR CAUDLE,  
*Assistant Attorney General.*

ELLIS N. SLACK,  
LEE A. JACKSON,  
HARRY BAUM,  
*Special Assistants to the  
Attorney General.*

DECEMBER, 1950

## APPENDIX

## Internal Revenue Code:

## SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a \* \* \* tax \* \* \*.

(26 U.S.C. 1946 ed., Sec. 11.)

## SEC. 22. GROSS INCOME.

(a) *General Definition*.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service \* \* \*, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. \* \* \*

(26 U.S.C. 1946 ed., Sec. 22.)

## SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1946 ed., Sec. 181.)

## SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

\* \* \* \* \*



(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

(26 U.S.C. 1946 ed., Sec. 182.)

#### SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

\* \* \* \* \*

(2) *Partnership and Partner*.—The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term “partner” includes a member in such a syndicate, group, pool, joint venture or organization.

\* \* \* \* \*

(26 U.S.C. 1946 ed., Sec. 3797.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.22(a)-1. *What included in gross income*.—Gross income includes in general compensation for personal services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, \* \* \*.

\* \* \* \* \*



Nos. 12,618 and 12,619

IN THE  
United States Court of Appeals  
For the Ninth Circuit

---

MOLLY A. HARKNESS,

*Petitioner,*

VS.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent,*

No. 12,618

(CONSOLIDATED  
CASES)

FLOYD J. HARKNESS,

*Petitioner,*

VS.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

No. 12,619

REPLY BRIEF FOR PETITIONERS.

---

PHILIP S. EHRLICH,

ALBERT A. AXELROD,

R. J. HECHT,

IRVING ROVENS,

2002 Russ Building, San Francisco 4, California,

*Attorneys for Petitioners.*

FILE

DEC 28 19





## Subject Index

---

I.	Page
Basic errors underlying respondent's argument .....	1
1. Respondent misconceives the scope of review .....	1
2. Respondent misconceives the rule of <i>Culbertson v. Commissioner</i> , 337 U.S. 733, 93 L.Ed. 1659 (1949) ...	1
II.	
Respondent correctly states certain of the applicable principles, but errs in his analysis of petitioners' argument ..	9
A. Purposes which motivated formation of partnership..	11
B. Relationship of parties .....	11
C. Conduct of parties during formative stages .....	11
D. Public notoriety given to formation and early operations of partnership .....	13
E. Partnership agreement .....	13
F. Respective abilities of parties .....	14
G. Capital contributions of children .....	15
H. Actual conduct of business under agreement .....	16
I. Actual control of income and purposes for which used	18
K. Partnership not formed for express purpose of reducing taxes .....	18
L. Actions of parties in subsequent years as evidencing intent of parties in entering into partnership .....	19
Conclusion .....	20

## Table of Authorities Cited

<b>Cases</b>	<b>Pages</b>
Commissioner v. Tower, 327 U.S. 280, 90 L. Ed. 670 (1946)	3
Culbertson v. Commissioner, 337 U.S. 733, 93 L. Ed. 1659 (1949) .....	2, 4, 5, 7, 10, 16
Dobson v. Commissioner, 321 U.S. 231, 88 L. Ed. 641 (1944)	3, 4
N.L.R.B. v. Union Pacific Stages, 99 Fed. (2d) 153 (C.C.A. 9, 1938) .....	3
Ritter v. Commissioner, 11 T.C. 234 (1948) .....	8
Ritter v. Commissioner, 174 F. (2d) 377 (1949) .....	8, 9
Royal Highlanders v. Commissioner, 1 T.C. 184 (1942) ....	6
Tindall v. Commissioner, 14 T.C. No. 125 (1950) .....	15
United States v. United States Gypsum Company, 333 U.S. 364, 92 L. Ed. 746 (1948) .....	4

## Codes

California Civil Code:	
Sections 174, 206 .....	11
Section 2419 .....	17
Internal Revenue Code, Section 1141(a) .....	4

## Rules

Federal Rules of Civil Procedure, Rule 52(a) .....	3
--	---

Nos. 12,618 and 12,619

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

---

MOLLY A. HARKNESS,

*Petitioner,*

vs.

No. 12,618

COMMISSIONER OF INTERNAL REVENUE,

*Respondent,*

(CONSOLIDATED  
CASES)

FLOYD J. HARKNESS,

*Petitioner,*

vs.

No. 12,619

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

**REPLY BRIEF FOR PETITIONERS.**

---

**I.**

**BASIC ERRORS UNDERLYING RESPONDENT'S ARGUMENT.**

1. **Respondent Misconceives the Scope of Review.**
2. **Respondent Misconceives the Rule of *Culbertson v. Commissioner*, 337 U.S. 733, 93 L.Ed. 1659 (1949).**

Certain basic errors underlie and permeate the whole of Respondent's argument as set forth in his brief. In substance, these errors may be stated as follows:

1. The Respondent has misconceived the scope of review of decisions of the Tax Court.

2. The Respondent misconceives the rule of *Culbertson v. Commissioner*, 337 U.S. 733, 93 L. Ed. 1659 (1949).

The Respondent contends that the findings and decision of the Tax Court should not be reversed because they are supported by the following evidence in the record:

(a) During the year 1943, Petitioners' children and their son-in-law did not contribute capital originating with them and rendered no services (Respondent's Brief, pp. 23-26).

(b) During the year 1943, the Petitioner, Floyd J. Harkness, was the manager of the partnership business and the only active partner, and the children and their son-in-law did not participate in the management (Respondent's Brief, pp. 26-28).

(c) During the year 1943, the children used their share of the partnership profits to pay principal and interest on the notes given by them to Petitioners, and to increase the capital of the partnership (Respondent's Brief, p. 30).

(d) During the year 1943, the share of the profits allocated to the children amounted to \$71,645.00 each, or a return on their investment of more than 200% (Respondent's Brief, p. 31).

It is the position of the Respondent that the ultimate finding of the Tax Court that Petitioners and



their children had no intent to join together in conducting the business of the partnership, is not erroneous because it is supported by the evidence above outlined. In other words, it is the position of the Respondent that the finding of the Tax Court is not vulnerable on review because it is supported by some evidence. In this connection it should be noted that the Respondent in his argument has not considered or discussed other relevant and material evidence in the record which should have been considered by the Tax Court in making its determination with respect to the reality of the partnership.

All of this indicates that Respondent misconceives the scope of review and the right of this Court on appeal to set aside the findings of the Tax Court if they be clearly erroneous (F.R.C.P., 52(a)), even though there may be some evidence in the record to support them. This Court is not compelled to accept findings arrived at by accepting part of the evidence and totally disregarding other convincing evidence. (*N.L.R.B. v. Union Pacific Stages*, 99 Fed. (2d) 153, 177 (C.C.A. 9, 1938.))

The basic error of Respondent on the question of the scope of review stems from his failure to recognize that the rule of *Dobson v. Commissioner*, 321 U.S. 231, 88 L. Ed. 641 (1944) applied by the Supreme Court in *Commissioner v. Tower*, 327 U.S. 280, 90 L. Ed. 670 (1946), is no longer controlling. The rule was legislated out of existence by Congress in 1948 when it amended Section 1141 (a) of the In-

ternal Revenue Code. This amendment provides that this Court may review the decisions of the Tax Court “in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury.”

Prior to 1948, and when the *Dobson* rule was still in effect, the findings of the Tax Court could not be disturbed if there was any evidence in the record to support them.

The question, therefore, before this Court, is not whether there is any evidence in the record to support the ultimate findings of the Tax Court, but whether the ultimate findings are clearly erroneous. In deciding this question, this Court should be guided by the oft-quoted language of the Supreme Court in *United States v. United States Gypsum Company*, 333 U.S. 364, 395, 92 L. Ed. 746, 766 (1948):

“A finding is ‘clearly erroneous’ when although there is evidence to support it, the reviewing court on the entire evidence is left with a definite and firm conviction that a mistake has been committed.”

A consideration of the entire evidence in this cause leads inevitably to the conclusion that a mistake has been committed. The Respondent being aware of this fact misconceives and misstates the rule in the *Culbertson* case, *supra*, in an attempt to persuade this Court not to review the entire evidence. In the Petitioner’s opening brief we reviewed and discussed at length events which occurred subsequent to the first

year in which the partnership operated, in an effort to show this Court that the conduct of the parties during those years led unavoidably to the conclusion that they had intended in good faith to join together in the conduct of a partnership business. Respondent would persuade this Court not to consider this evidence, as well as other evidence in the Record. This evidence shows, among other things, that Petitioners' son and son-in-law, in 1942-43 made a present commitment to render services in the future, and that this engagement was fulfilled to the letter. This evidence likewise shows that after Petitioners' children performed their obligation to pay their debt to Petitioners—a debt secured by their respective interests in the assets and income of the partnership—they had free and untrammelled use and enjoyment of their respective shares of the profits of the partnership. Respondent would persuade this Court not to consider this evidence on the basis of certain language which appears in the opinion of Mr. Chief Justice Vinson in the *Culbertson* case. There the Chief Justice stated:

“\* \* \* The vagaries of human experience precludes reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.”

To the foregoing statement there is appended a footnote which reads as follows:

“The *reductio ad absurdum* of the theory that children may be partners with their parents before they are capable of being entrusted with



the disposition of partnership funds or of contributing substantial services occurred in *Tinkoff v. Commissioner*, 120 Fed. (2d) 564, where a taxpayer made his son a partner in his accounting firm the day the son was born.”

On the basis of the statements above quoted, the Respondent concludes that it is the law that the events to which we have alluded may not be considered in appraising the reality of the partnership, because they did not occur during the taxable year in question (Respondent’s Brief, pp. 26-29). In so doing, the Respondent confuses the purport of the Chief Justice’s statements with the effect of a rule of administrative convenience. The Respondent believes that because “net income must be computed with respect to a fixed period, and usually that period is twelve months and is known as the taxable year”,<sup>1</sup> that all evidential factors which may be considered in determining the question of intent must occur during the period, upon the basis of which, net income must be computed, and that if they do not, such evidential factors must be disregarded.

In making the above quoted statements the Chief Justice was not laying down a rule of evidence. It is clear from the language used that he was appraising the facts disclosed by the Record in that case in the light of human experience. He determined that, measured by this standard, the commitments made by the *Culbertson* children had only a remote possibility

---

<sup>1</sup>*Royal Highlanders v. Commissioner*, 1 T.C. 184, 191 (1942).



of fulfillment, and were, therefore, insufficient consideration to support the bargain made with the parents.

Experience teaches that most agreements and engagements made by men are entered into on the basis of probabilities and with a reasonable expectation that they will be fulfilled. These agreements and engagements are not held unenforceable and invalid merely because it is not *absolutely certain* they can or will be fulfilled. In the case used by the Chief Justice to illustrate the *reductio ad absurdum* of alleged family partnerships, there could be no probability or reasonable expectation that a newly born infant would fulfill a commitment which he had no power to make and which had been made for him by his father. However, as we move from this ridiculous extreme to cases where adults are concerned and where the evidence discloses that they are ready, willing and able to fulfill their engagements at the very earliest opportunity, the expectations are reasonable and the probability of the performance of commitments increases to the point that neither the Respondent nor the Tax Court may substitute their judgment for that of the parties. We are not here dealing with cases involving infants, school boys and college students. The statements of the Supreme Court in the *Culbertson* case were addressed to a Record that showed that of the four Culbertson children only one of them was an adult and sufficiently mature to determine with a reasonable degree of probability his future conduct; of the other

Culbertson children, two were in high school and a third in college. Accordingly, when these statements were made, Chief Justice Vinson had in mind that as to the boys attending high school, the probability of fulfilling a commitment to render future services was remote and that the same could also be said of the boy who was in college. It is clear, therefore, that rulings made in cases involving infants and adolescents are not applicable here.

The Respondent seeks to further buttress its erroneous position by what is stated in the brief and laconic opinion of the Court of Appeals for the Fourth Circuit in *Ritter v. Commissioner*, 174 F. (2d) 377 (1949). (Respondent's Brief, p. 19.) That this case has no application here is made evident by what appears in the findings and opinion of the Tax Court in *Ritter v. Commissioner*, 11 T.C. 234 (1948). The findings and opinion of the Tax Court disclose the following:

(a) The alleged partner, a college boy, acquired an interest in his father's contracting business by gift.

(b) The father, during the existence of the alleged partnership, entered into transactions not in the name of the partnership, but in his name as an individual.

(c) The son, during the existence of the partnership, did not withdraw the share of partnership profits allocated to him.

The foregoing are important differences which clearly distinguish this case from the *Ritter* case. In the *Ritter* case the findings of the Tax Court, on the entire evidence, were clearly correct, not clearly erroneous as they are here.

---

## II.

### RESPONDENT CORRECTLY STATES CERTAIN OF THE APPLICABLE PRINCIPLES, BUT ERRS IN HIS ANALYSIS OF PETITIONERS' ARGUMENT.

Respondent states at pages 13 and 14 of his brief:

“The controlling principles were enunciated in *Commissioner v. Tower*, 327 U.S. 280, and *Lusthaus v. Commissioner*, 327 U.S. 293, were reaffirmed in *Commissioner v. Culbertson*, 337 U.S. 733 and have been applied by this court and other courts in a legion of family partnership cases. ‘The issue is who earned the income and that issue depends on whether this husband and wife (here a father and children) really intended to carry on business as a partnership.’ *Commissioner v. Tower*, *supra*, page 289. As stated in the *Culbertson* case (page 742) the test is ‘whether considering all the fact \* \* \* the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise’ ”.

Petitioners agree that the foregoing is a correct statement of the principles that should govern this case. However, they sharply disagree with Respondent



in his interpretation of the contentions they have advanced in support of their argument as to the bona fides of this partnership. Respondent states at page 21 of his brief:

“Stripped to its essentials, his argument reduces itself to the contention flatly rejected in the *Culbertson* case that the Tax Court was obliged to conclude that both his children were partners during the taxable year merely because he sold portions of his capital to each with the expectation that one of them (his son) would contribute services in future years.”

Whether or not the cases cited and principles stated by Respondent stand for the proposition he advances is of no importance on this appeal, as Petitioners contend that Respondent's interpretation of their argument is totally erroneous. A reading of their opening brief discloses that Petitioners' entire argument is based on the good faith and intent of the parties in entering into the partnership as measured by the tests set forth by the Supreme Court in *Commissioner v. Culbertson*. Petitioners argued the validity of the sales to the children and the commitments of the two boys to render services to the partnership as only two of the many factors to be taken into account by this court in passing on the bona fides of the arrangement. That Respondent is clearly in error in his interpretation of Petitioners' argument and that Petitioners have based their argument on the factors set forth in *Culbertson* for determining the bona fide intent of the



parties will very clearly be shown in the summary of the Record that follows:

**A. Purposes Which Motivated Formation of Partnership.**

1. The desire of Harkness, Sr., to obtain services of son and son-in-law (R. 253).

2. The need for increasing capital of the business and the satisfaction of this need by getting persons into business who agreed it was essential and proper to allow annual profits to accumulate (R. 254).

3. A decline in profits was anticipated (R. 254).

4. The desire of Harkness, Sr., to give his children an opportunity to make good (R. 255).

5. Harkness, Sr., would have entered arrangement regardless of tax consequences (R. 256).

**B. Relationship of Parties.**

1. Partnership composed of father, mother and two adult children (R. 259).

2. One child married with distinct economic and family unit (R. 252).

3. Son capable of supporting himself (R. 252).

4. No obligation of support owed to either child by taxpayers (Cal. Civil Code 174, 206).

**C. Conduct of Parties During Formative Stages.**

1. Mature deliberations months before partnership formed between all parties concerned (R. 256).

2. Harkness, Jr., eagerly accepted father's offer to become a partner. This had been his desire for many years (R. 246).

3. Tax Court finding: Petitioners and Harkness, Jr., then definitely planned to convert the business into a partnership, starting in 1943 (R. 256).

4. Daughter given opportunity to invest in United Packing Co., or some other enterprise (R. 256).

5. Daughter and husband debated at length whether she should invest in United Packing Co. (R. 256).

6. Daughter and husband discussed original agreement with legal counsel (R. 224-225).

7. Daughter decided to invest in United Packing Co., but would not sign original articles until provisions as to control of business and purchase of deceased partner's interest were changed (R. 256-257).

8. Tax Court finding: By November 1942, Petitioners and both their children generally agreed to the formation of a partnership for the operation of United Packing Co. in the coming year though the details of the partnership relation had not been worked out (R. 256-257).

9. Modifications sought by daughter discussed in January, 1943 (R. 259).

10. Daughter withdraws objections when original draft altered to meet her demands (R. 259).

#### **D. Public Notoriety Given to Formation and Early Operations of Partnership.**

1. Certificate of co-partnership transacting business under fictitious name signed by all parties, published in local paper and filed with Fresno County Recorder (R. 115, 257).

2. Immediately after formation of partnership, letterheads changed to show business being conducted as partnership (R. 188).

3. Grant deed to River Ranch which was recorded, had attached thereto bill of sale which showed that personal property was transferred to Petitioners and their children as copartners, doing business under the firm name and style of United Packing Co., (R. 72).

#### **E. Partnership Agreement.**

1. To bind partnership, Harkness, Sr. needed consent of one other copartner (R. 263-264).

2. No partner could transfer his share in partnership without written consent of two other copartners (R. 264).

3. Harkness, Sr. required to render account every year (R. 264).

4. Capital could only be increased by action of three partners (R. 266).

5. Capital only could be reduced and profits withdrawn by action of three partners (R. 265).

6. In event partner wished to sell interest, he must first offer it to remaining partners (R. 266).

7. If any partner became deceased, remaining partners given right to purchase his interest (R. 267).

8. Partners agreed to share equally in losses. (R. 269).

9. Harkness, Sr.'s salary set at 75% of first \$100,000 of partnership net income (R. 259).

10. In no phase of business could Harkness, Sr. act alone except in every day transactions of business.

The Tax Court at no place in its findings and opinion casts any doubt upon the reality and validity of partnership agreement.

**F. Respective Abilities of Parties.**

1. Harkness, Jr. worked in father's business during summers from 1934 to 1941 (R. 252).

2. Harkness, Jr. worked full time from June, 1941, through January, 1942 (R. 252).

3. Harkness, Jr. was thoroughly experienced in growing, packing and shipping of fruits and vegetables (R. 226-228).

(a) He had supervised and managed packing operations.

(b) He had been in charge of office.

(c) He had taken part in every phase of business.

4. William Colgate acquired knowledge of irrigation, lifeblood of the area, working for Peerless Pump Co. (R. 253).

5. Colgate expressed desire to make agriculture his life's work (R. 253).



6. Colgate majored in commerce in college; this training added to his practical experience, made him a man well qualified to undertake the type of work required by the business of the partnership (R. 253-254).

On the basis of above factors, Harkness, Sr. had valid reason and business purpose in contracting to secure the services of the two boys for the partnership.

#### **G. Capital Contributions of Children.**

1. Harkness, Jr. purchased interest with promissory note plus credit on books of sole proprietorship (R. 276).

2. Harriet Colgate purchased interest with note joined in by her husband (R. 276).

3. Notes were unconditional promises to pay (R. 190).

4. Notes secured by children's interest in United Packing Co. (R. 119-121).

5. Notes secured by income to be derived from partnership earnings (R. 263).

6. Notes secured by ability of Harkness, Jr. and William Colgate to earn.

7. Notes actually paid out of profits<sup>2</sup> (R. 280).

8. Harkness, Sr. also received as consideration the present commitments of Harkness, Jr. and

---

<sup>2</sup>*Tindall v. Commissioner*, 14 T.C. No. 125 (1950). A promissory note paid out of profits of a partnership is a valid capital contribution.

William Colgate to render services as soon as circumstances permitted.<sup>3</sup>

9. Profits from operation of River Ranch in which each child owned a one-eighth interest as a tenant in common (R. 269-270), went into the co-partnership (R. 270).

#### **H. Actual Conduct of Business Under Agreement.**

1. Prior to entering into partnership, Harkness, Sr., as sole proprietor and manager of the community, had complete unfettered power and control over the income, business and assets of United Packing Co.

2. After the formation of the partnership the following restrictions were imposed upon Harkness, Sr.:

(a) In order to bind the properties of the business he was required to obtain the consent of a partner (R. 263-264).

(b) To increase or reduce the capital of the business he had to secure the consent of two partners (R. 265).

(c) In order to fix the salaries of employees he had to secure the consent of two partners (R. 265).

(d) In order to transfer his share in the partnership he had to secure the consent of two partners (R. 264).

---

<sup>3</sup>Mr. Justice Burton in *Commissioner v. Culbertson*, supra, 337 U.S. 749, " \* \* \* a present commitment to render future services to a partnership is in itself a material consideration to be weighed with all other material considerations for the purposes of taxation as well as other partnership purposes."

3. After the formation of the partnership, Harkness, Sr., was required to:

(a) Account to other partners for his actions in managing business (R. 265).

(b) Offer his interest first to other partners in event he wished to sell (R. 266).

(c) Act for the best interest of all parties concerned in his operation of the business (R. 264).

(d) Not do any act whereby the capital or property of the co-partnership could be taken by execution (R. 265).

(e) Punctually pay his own separate debts (R. 266).

(f) Transfer his interest at book value to other partners in event he became financially involved in outside interests so that his share in partnership would become involved (R. 266).

4. In addition, Harkness, Sr.'s right to possess the partnership property formerly unlimited, could only be exercised for partnership purposes (California Civil Code 2419).

5. Record discloses that in connection with the one transaction, in 1943, that fell outside the ordinary course of the management of the business, the purchase of the River Ranch, the children were consulted and their consent obtained (R. 270).

No principle of law requires that the actual day to day operation of successful business must be altered in order to establish a bona fide partnership.

# **I. Actual Control of Income and Purposes For Which Used.**

1. 1943 income—children's share: (a) Used to pay income taxes. (b) Used to pay valid obligations they owed parents (R. 280). (c) Remainder left in business in fulfillment of one of purposes motivating formation of partnership.

2. Subsequent income. (a) Proportionate distribution to members of partnership (Ex. 6F—R. 55). (b) Harkness Jr. withdrew \$121,484.51 from a gross income after taxes of \$225,695.26 (Ex. 6F—R. 55). (c) Harriet Colgate withdrew \$100,138.48 from a gross income after taxes of \$223,171.01 (Ex. 6F—R. 55). (d) Record discloses no part of income credited to children ever went back to parents except part used in repayment of notes.

The foregoing discloses that we have here more than “a mere paper reallocation of income among the family members”.

# **K. Partnership Not Formed For Express Purpose of Reducing Taxes.**

1. Harkness, Sr. expected income of business to diminish in 1943 (R. 144).

2. Harkness, Sr. would have entered partnership regardless of any tax saving possibilities (R. 149).

3. Tax Court finding: While Harkness, Sr. consulted a lawyer concerning the feasibility of converting his business into a partnership and was thus aware of the tax savings possibilities inherent therein, yet this fact was only a secondary consideration with him



and he would have entered into this arrangement regardless thereof (R. 255-256).

No evidence, such as was found in *Tower* and *Lusthaus* that Harkness, Sr. was faced with prospect of large profits and correspondingly large income taxes and sought legal advice on how to reduce taxes.

**L. Actions of Parties in Subsequent Years as Evidencing Intent of Parties in Entering Into Partnership.**

1. William Colgate immediately upon his release from the Army went to work for the partnership and has rendered substantial services of a supervisory and managerial nature to the partnership up to and including the date of the hearing—January, 1949 (R. 217-222).

2. Floyd Harkness, Jr. immediately upon his release from the Army was appointed assistant general manager of the partnership and has rendered substantial managerial services to the business up to and including the date of the hearing—January, 1949 (R. 230, 241-242).

Petitioners believe the above summary of the facts in this case sufficiently answers the contentions set forth at pages 23 to 33 of Respondent's brief, except in one particular. Respondent states at page 25:

“Taxpayer completely misconceives the Supreme Court's holding in the Culbertson case in contending (Br. 54-58) that the children must be deemed partners during the taxable year 1943 because of events which occurred in subsequent years.”

Petitioners desire to make clear to this Court that this has never been their contention. Petitioners' sole contention in this regard being this Court may look at events which took place subsequent to the year 1943 as bearing on the question of the good faith and bona fide intent of the parties in entering into the partnership.

---

### CONCLUSION.

Petitioners again point out that on the vital issue involved in this case, the *intent of the parties*, Respondent has offered no evidence. There is no evidence in the record to impugn the bona fides of this partnership or the good faith of the parties involved. Petitioners contend that the ultimate finding of the Tax Court in this case, that the parties had no intent to enter into a partnership in the year 1943, is clearly erroneous, and that for this reason the decision of the Tax Court must be reversed.

Dated, San Francisco, California,  
December 26, 1950.

Respectfully submitted,

PHILIP S. EHRLICH,  
ALBERT A. AXELROD,  
R. J. HECHT,  
IRVING ROVENS,  
*Attorneys for Petitioners.*

Nos. 12,618 and 12,619  
IN THE  
United States Court of Appeals  
For the Ninth Circuit

---

MOLLY A. HARKNESS,

*Petitioner,*

vs.

No. 12,618

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

(CONSOLIDATED  
CASES)

FLOYD J. HARKNESS,

*Petitioner,*

vs.

No. 12,619

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

PETITION OF PETITIONERS  
MOLLY A. HARKNESS AND FLOYD J. HARKNESS  
FOR A REHEARING.

JAN 25 195

PHILIP S. EHRLICH, PAUL P. O'BRIEN

ALBERT A. AXELROD,

R. J. HECHT,

IRVING ROVENS,

2002 Russ Building, San Francisco 4, California,

*Attorneys for Petitioners.*





## Subject Index

---

	Page
I.	
In these cases the resolution of the issue whether the Harkness children were the "true owners" of capital contributed to the partnership was decisive of the question of "intent". This issue could be resolved only by applying to the facts the definitions of "true owners" set forth in the Clifford, Horst and Tower cases. The tax court made no finding on the issue of "ownership". The tax court's failure to so find was called to the attention of this court, and this court was requested to review the record in the light of the definitions contained in the above cases in determining whether the ultimate finding of the tax court with respect to "intent" was supported by substantial evidence. This court did not so review the record.....	2
II.	
In affirming the decision of the tax court, this court has overlooked the correct meaning of the term "bona fide"; it has likewise overlooked the presumption of good faith and has overlooked the rule which requires the tax court not to reject uncontradicted and unimpeached evidence....	17

## Table of Authorities Cited

Cases	Pages
Commissioner v. Tower (1945), 327 U.S. 280, 90 L.Ed. 670 .....	2, 3, 5, 6, 16
Culbertson v. Commissioner (1947), 6 TCM 692.....	8, 12, 16
Commissioner v. Culbertson (1948), 337 U.S. 733, 93 L.Ed. 1639 .....	3, 7, 14, 15
Culbertson v. Commissioner (1948), 168 F. (2d) 979.....	12, 13
Greenberger v. Commissioner (C.A. 7, 1949), 177 F. (2d) 990 .....	4
Helvering v. Clifford (1939), 309 U.S. 331, 84 L.Ed. 788 .....	2, 3, 5, 6, 16
Helvering v. Horst (1940), 311 U.S. 112, 85 L.Ed. 75...2, 3, 5, 6, 16	
Lawton v. Commissioner (C.C.A. 6-1947), 164 F. (2d) 380	23
Mayson Mfg. Co. v. Commissioner (C.A. 6-1949), 178 F. (2d) 115 .....	22
Millslagle v. Olson (C.C.A. 10-1942), 128 F. (2d) 1015....	2
U. S. v. California Midway Oil Co. (D.C.S.D., Cal., 1919), 259 Fed. 343 .....	20
Ware v. Hylton (1796), 3 U.S. (3 Dall.) 196, 1 L. Ed. 568	18

## Miscellaneous

H.R. No. 586, 82d Congress, 1st Session, p. 33.....	5
1 Jones, Commentaries on Evidence, Section 13, pages 99-100	21

Nos. 12,618 and 12,619

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

---

MOLLY A. HARKNESS,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

No. 12,618

(CONSOLIDATED  
CASES)

FLOYD J. HARKNESS,

*Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

No. 12,619

**PETITION OF PETITIONERS**

**MOLLY A. HARKNESS AND FLOYD J. HARKNESS**

**FOR A REHEARING.**

---

*To the Honorable William Denman, Chief Judge, and  
to the Honorable Circuit Judges of the United  
States Court of Appeals for the Ninth Circuit:*

This Honorable Court, by its decision and opinion  
filed on December 28, 1951, affirmed the decisions of  
the Tax Court in the above-entitled causes.

This petition does not reargue the issues determined by the opinion. The purpose of this petition is to call attention to material matters of fact and law inadvertently overlooked by this Court, as shown by its opinion (*Millslagle v. Olson* (1942, CCA 10), 128 F. (2d) 1015, 1016). Petitioners, therefore, respectfully call attention to, and submit as reason for granting their petition for a rehearing, the following material matters of law and of fact inadvertently overlooked by the Court:

### I.

IN THESE CASES THE RESOLUTION OF THE ISSUE WHETHER THE HARKNESS CHILDREN WERE THE "TRUE OWNERS" OF CAPITAL CONTRIBUTED TO THE PARTNERSHIP WAS DECISIVE OF THE QUESTION OF "INTENT". THIS ISSUE COULD BE RESOLVED ONLY BY APPLYING TO THE FACTS THE DEFINITIONS OF "TRUE OWNERS" SET FORTH IN THE CLIFFORD, HORST AND TOWER CASES.<sup>1</sup> THE TAX COURT MADE NO FINDING ON THE ISSUE OF "OWNERSHIP". THE TAX COURT'S FAILURE TO SO FIND WAS CALLED TO THE ATTENTION OF THIS COURT, AND THIS COURT WAS REQUESTED TO REVIEW THE RECORD IN THE LIGHT OF THE DEFINITIONS CONTAINED IN THE ABOVE CASES IN DETERMINING WHETHER THE ULTIMATE FINDING OF THE TAX COURT WITH RESPECT TO "INTENT" WAS SUPPORTED BY SUBSTANTIAL EVIDENCE. THIS COURT DID NOT SO REVIEW THE RECORD.

Briefly stated, the reasoning of this Court in upholding the decision of the Tax Court is as follows:

Harkness "looked forward to having the assistance not only of the son, but of the son-in-law". But

---

<sup>1</sup>*Helvering v. Clifford* (1939), 309 U.S. 331, 84 L.Ed. 788;  
*Helvering v. Horst* (1940), 311 U.S. 112, 85 L.Ed. 75;  
*Commissioner v. Tower* (1945), 327 U.S. 280, 90 L.Ed. 670.



Harkness knew that he could not have, and, in fact, did not receive the desired assistance *during 1943*, the tax year in question. Therefore, Harkness did not intend that the partnership should become effective until "the desired help of the young men would become available".

Petitioners have no quarrel with the premises adopted by the Court. The partnership agreement, the supplemental agreement of January 4, 1943 (R. 258-269), and the testimony of the parties clearly show that everyone concerned knew that the young men would not be able to render services until their release from the Army. Petitioners, however, do contest the validity of the conclusion reached by the Court from these premises.

This conclusion is obviously at odds with the record and the applicable decisions. The record shows formal, *unconditional* conveyances of real and personal property made by the petitioners to their children in 1943 (R. 257-258; 261-262; 269-270). Certainly, if the children became, as a result of these conveyances, "true owners", in 1943, of the property contributed to the partnership, as that term is defined in the *Clifford*, *Horst* and *Tower* cases, *supra*, then under the doctrine of *Commissioner v. Culbertson* (1948), 337 U.S. 733, 748, 93 L. Ed. 1639, 1668, there was an intent that the children be partners in the business in 1943, and the fact that the son and son-in-law did not render services during that year, is immaterial under the circumstances shown by this record.

The Tax Court found that during the year 1943 there was no change in the operation of *United Packing Co.* over prior years, and that the business was still completely under the control of Harkness, Sr. (R. 270). It may be argued from these findings that the powers exercised by Harkness in some manner detracted from the children's "true ownership" of the capital contributed to the partnership. However, this argument cannot be made because the Tax Court did not find that Harkness, Sr., exercised the powers thus given to him, not in his fiduciary capacity, as representative of the absent partners, but as owner and as manager of the community. The absence of such a finding is fatal to any contention that the children were not the "true owners" of the real and personal property conveyed to them during the year 1943.

The Courts and Congress have both recognized that so long as the powers of management are exercised by the transferor of property in an intra-family transaction as a fiduciary, and not as owner, the exercise of such powers in no way detracts from the *bona fides* of the transaction. In support of this statement we cited in our opening brief the case of *Greenberger v. Commissioner*, (C.A. 7, 1949), 177 F. (2d) 990, 994. Congressional recognition has been given to this principle in the House Report accompanying the Revenue Act of 1951. There, the House Ways and Means Committee said:

"Not every restriction upon the complete and unfettered control by the donee of the property

donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the transferee. *In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit.*" (Emphasis supplied.)

H.R. No. 586, 82d Congress, 1st Session, p. 33.

It is apparent, therefore, that the conclusion of this Court upholding the decision of the Tax Court results from a failure to consider the facts with respect to these conveyances, and from a failure to test the reality of these conveyances under the definitions set forth in *Clifford*, *Horst* and *Tower*, supra. In the absence of anything in this Court's opinion explaining this Court's failure to consider these vital facts and the applicable law, we must hazard that this resulted either from inadvertence or from certain unexpressed, invalid assumptions.

If not the result of inadvertence, then the conclusion reached by this Court requires the tacit assumption that petitioners had attached to these formal and *unconditional* conveyances a hidden and unexpressed condition precedent which rendered the chil-



dren's interest in the property conveyed merely contingent and not vested. Of course, if this Court or the Tax Court indulged in such an assumption, there could be no good reason for applying the tests ordained by *Clifford, Horst and Tower*, supra. However, such an assumption, it must be conceded, can only be based on suspicion and surmise. There is implicit in this assumption a suspicion that no man in his right mind, particularly a father, would give to his children property without making sure—first—that he got what he bargained for. There is likewise implicit in this assumption surmises as to what Harkness, Sr., might have done had he been unable to secure the desired assistance of his son and son-in-law for any reason, including death, disability or a change in heart as to a career. It could be surmised that in the event, disability or failure to render desired assistance because of some other cause that Harkness, Sr., would have sought to recapture from his children or their heirs either the property conveyed or the income derived therefrom, or both. It could likewise be surmised that Harkness, Sr., had in case such an event came to pass, extracted from his children a secret promise to reconvey to him the property or the income, or both. Fortunately, under our system of jurisprudence, findings may not be based on surmises or suspicions.

The idea that there may have been a suspensive condition which prevented the vesting of the property in the children would be, of course, a palpable afterthought. At the time these causes were tried



(January 11, 1949)<sup>2</sup> and briefed before the Tax Court, the Respondent and certain Judges of the Tax Court were proceeding on the theory that the absence of vital services and original capital, without more, rendered all family partnerships ineffective for tax purposes. The Respondent based his notices of deficiencies herein on this theory (R. 272), and the Attorney representing the Respondent at the trial of these causes, upon making his opening statement, stated that his case was based on this theory (R. 101-102). There was, therefore, no reason at the time these causes were tried to make any inquiry respecting any condition precedent that might have been attached to the conveyances, and, in fact, no attempt was made by counsel or the Tax Court to elicit any evidence which might have disclosed such a condition, or from which an inference as to such a condition might have been drawn.

*Commissioner v. Culbertson* was decided after these causes had been tried and briefed, but before the deficiencies determined by the Respondent herein had been affirmed by the Tax Court. The decision of the Supreme Court in *Commissioner v. Culbertson*, as is conceded, entirely destroyed Respondent's original theory of the case, and the Tax Court was compelled to decide these causes on a theory other than the one which merely called for the mechanical application to the record of the "vital services—original capital" test. The Tax Court, therefore,

---

<sup>2</sup>R. 82.

evolved herein, for the purpose of affirming the Respondent's determination of deficiencies, the theory of a hidden condition precedent which would make ineffectual the unconditional conveyances of property made by petitioners to their children in 1943. This device enabled the Tax Court to avoid the duty cast upon it by the Supreme Court of making a finding with respect to "intent" based on the resolution of the issue whether the children were the "true owners" of the property contributed to the partnership.

The theory thus evolved enabled the Tax Court to state that there was "an indefinite *future* plan to operate United Packing Co. as a genuine partnership." This theory and this statement both have their origin in the first *Culbertson* decision (*Culbertson v. Commissioner* (1947), 6 TCM 692). There, the Tax Court found on the basis of *express conditions* set forth in written instruments that the children were "to acquire an interest in the business in the *future* \* \* \*." (6 TCM 700). To show that it is not possible to compress the record herein into the "future" plan mold of the *Culbertson* case, it is necessary to make brief reference to the facts of that case and to accompany it on its peregrination from the Tax Court to the Supreme Court.

The record of the *Culbertson* case shows that Mr. and Mrs. Culbertson owned certain community property used in a cattle business. They had five children—four sons and a daughter. In late October or November of 1939, Mr. and Mrs. Culbertson entered into an oral agreement of partnership with their sons.

On November 6, 1939, the Culbertsons executed a bill of sale in favor of their sons covering a one-half undivided interest in a herd of cattle. On January 1, 1940, at the beginning of the first taxable year, the sons were 24, 22, 18 and 16 years of age, respectively. The daughter was then 14 years old. The oldest son worked in the parents' business and the others were engaged in acquiring an education.

In December, 1939, Culbertson made application to a lending institution for a loan of funds with which to conduct the operations of his business. At that time, he informed the manager of the institution of the oral agreement of partnership with his minor children. Upon learning these facts, the manager advised Culbertson to have prepared some kind of document which would qualify him to do business on behalf of the minors. Pursuant to this advice Culbertson had an attorney prepare such a document. This document was executed on December 8, 1939, to be effective January 1, 1940. The Culbertsons purported by this instrument to create a limited partnership with their sons and to convey to them undivided interests in their property. The language disclosed that the conveyance of property to the sons was entirely conditional and that the Culbertsons retained every incident of ownership.

The document recited that the limited partnership was formed and the conveyance was made because the parents desired to establish the sons "*in business, as and when they arrived at a proper age to engage in business,*" and to induce them "*after they*



reach such a state of maturity, to contribute their time and services in building up and establishing a common family estate.”

Under the terms of this instrument, the parents reserved unto “themselves the sole and exclusive right and control and management of such properties herein conveyed \* \* \* *until the time the youngest of our said sons living shall have arrived at the age of twenty-one years.*” The parents likewise reserved to themselves the right to manage without any restriction and without obtaining the verbal or written consent of the sons.

The instrument also provided that the sons would have no right to enjoy in any manner the interests allegedly conveyed until the youngest had reached the age of twenty-one.

The above-described document was executed without the knowledge of the four sons, and the oldest of them did not learn of its existence until some time after May, 1943.

On or about December 31, 1940, Mr. and Mrs. Culbertson executed another document whereby they purported to convey to their fourteen-year-old daughter an undivided interest in their business. This instrument made direct reference to the one executed in favor of the sons, and expressly recited that under its terms “*conditional conveyance*” of undivided interests had been made to the sons.

Culbertson was enabled by reason of these instruments to borrow money without involving the minor children.



The Culbertsons, thereafter, filed tax returns showing their children as partners. In 1943, a revenue agent questioned the validity of the alleged partnership. The Culbertsons, for this reason, caused their children to file a suit against them on February 23, 1944, in a Texas Court, wherein they prayed that the Court declare the above-described instruments void, and for a decree declaring that the alleged partnership was in all things valid. A judgment granting the relief prayed for was entered by the Texas Court on February 26, 1944.

When the Tax Court was called for the first time to determine whether or not there existed a valid partnership between Mr. and Mrs. Culbertson and their children, it resolved the issue against the Culbertsons on the basis of a conflict in the evidence. The Culbertsons claimed that the true agreement between them and their children was the oral agreement which preceded the execution of the instruments used for the purpose of borrowing money. The Tax Court refused to believe that Mr. Culbertson would misrepresent the true facts to the manager of the lending institution and on this basis determined that the aforementioned instruments evidenced the true agreement between the Culbertsons and their children. Since these instruments by their terms described the conveyances to the children as "*conditional*" the Tax Court, in making its decision, stated:

"By these instruments it appears that the boys (and daughter) are to acquire an interest in the business in the *future*, and we cannot pass them

off lightly as does petitioner on brief.” (Emphasis by the Tax Court.)

*Culbertson v. Commissioner*, supra, 6 TCM 700.

To the above quotation, the Tax Court added the following significant statement:

“Moreover, the fact that at the time of the Trial the boys were not, with the exception of W. O., Jr., (and perhaps Richard—‘Richard has some lately’), taking part in the operation of the ranch, is hardly consistent with the petitioner’s contention or the idea that Coon thought Culbertson could not operate the business.”

The Tax Court, in its opinion, which is a long one, took occasion to discuss the fact that the Culbertson children had not contributed services or capital originating with them, but it should be noted that its decision invalidating the alleged partnership was not based on the failure to render services or to contribute original capital, but on the instruments which show that the children were not the “true owners” of the capital contributed to the alleged partnership because of the conditional nature of the conveyances.

The Culbertsons, after the decision of the Tax Court, filed a petition for review in the Court of Appeals for the Fifth Circuit. The Court of Appeals on review reversed the decision of the Tax Court (*Culbertson v. Commissioner* (1948), 168 F. (2d) 979). The Court of Appeals in so reversing the Tax Court took a different view of the case and decided that the instruments that had decided the issue against the Culbertsons were executed by them without knowl-

edge of their legal effect. This might have been sufficient to justify the reversal of the Tax Court's decision. However, the Court of Appeals went further than the necessities of the case required and stated, by way of dictum, that it was not necessary to the validity of a partnership that the partners contribute presently either services or capital. The Court of Appeals stated its point as follows:

"Neither statute, common sense, nor impelling precedent requires the holding that a partner must contribute capital or render services to the partnership prior to the time he is taken into it. These tests are equally effective whether the capital and the services are presently contributed and rendered or are later to be contributed or to be rendered."

*Commissioner v. Culbertson*, supra, 168 F. (2d) 983.

The above rather extraordinary statement no doubt influenced the Supreme Court to grant certiorari on petition of the Commissioner.

The Supreme Court, in reviewing the decision of the Court of Appeals, immediately took issue with the above-quoted statement and said:

"If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax year in question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years. \* \* \*

"The intent to provide money, goods, labor, or skill some time in the future cannot meet the de-



mands of §§ 11 and 22(a) of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon good faith, intent as to future conduct as a basis for the present taxation of income."

*Commissioner v. Culbertson*, supra, 337 U.S. 739-740, 93 L. Ed. 1664.

After having so admonished the Court of Appeals, the Supreme Court went on to tell the Tax Court that it too was in error when it resolved the issue of the validity of a partnership by applying the "vital services—original capital" test. In so doing, the Supreme Court said:

"We turn next to a consideration of the Tax Court's approach to the family partnership problem. It treated as essential to membership in a family partnership for tax purposes the contribution of either 'vital services' or 'original capital'. Use of these 'tests' of partnership indicates, at best, an error in emphasis. It ignores what we said is the ultimate question for decision, namely, 'whether the partnership is real within the meaning of the Federal Revenue Laws' and makes decisive what we described as 'circumstances' (to be taken) 'into consideration' in making that determination."

*Commissioner v. Culbertson*, supra, 337 U.S. 741, 93 L. Ed. 1665.

The foregoing makes it clear that the Supreme Court rejected the extreme views expressed both by



the Court of Appeals and by the Tax Court. In another portion of its opinion the Supreme Court set forth for the future guidance of the Tax Court the correct rule for decision.

Nowhere in the Tax Court's opinion or in the opinion of this Court is there any reference to this rule. The Tax Court quoted only such parts of the Supreme Court's opinion in *Culbertson* as still bear some resemblance to the old "vital services—original capital" test. The Supreme Court made it very clear that the burden, heavy as it might be, of proving the bona fides of a partnership arrangement could be carried by showing that the members of the family partnership had either rendered services or had made contributions of capital of which they were the true owners. In remanding the *Culbertson* case to the Tax Court, the Supreme Court expressed this rule as follows:

"The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, *or because of contributions of capital of which they were the true owners*, as we have defined that term in the *Clifford, Horst and Tower* cases?"

*Commissioner v. Culbertson*, 337 U.S. 748, 93 L. Ed. 1668.

The point that stands out in the Tax Court's decision is the fact that it at no time *found* that petitioner's children were not the "true owners" of the capital contributed by them to the partnership. In its opinion it makes many statements with reference to the dominion and control that Harkness, Sr., exercised over the business of the partnership during the years in which the young men were in the Army. These, however, *are not findings*. They are merely erroneous expressions of opinion contrary to its findings of fact. In addition, the Tax Court's opinion contains nothing which indicates that it applied the definitions set forth in the *Clifford, Horst and Tower* cases to either its findings of fact or the record as a whole for the purpose of determining whether or not petitioners' children were or were not the true owners of the capital contributed by them.

The record herein and the Tax Court's own findings are such that the Tax Court could not, in endeavoring to affirm the decisions of the respondent, apply the mandate of the Supreme Court, and for this reason the Tax Court resorted to the device of attempting to compress the record herein into the "future plan—condition precedent" mold of the first *Culbertson* decision.

In our opening brief, we pointed out that the ultimate finding on "intent" of the Tax Court was not supported by substantial evidence because neither the record nor the findings of the Tax Court established that petitioners' children were not "true owners" of the capital (Brief for Petitioners, pp. 17; 34; 41-46).

It is respectfully urged, therefore, that this Court was led by the device employed by the Tax Court to overlook the fact that the Tax Court had not made any finding on the issue of ownership. This Court, for the same reason, failed to review the record for the purpose of determining whether the ultimate finding of the Tax Court with respect to "intent" was supported by substantial evidence.

---

## II.

**IN AFFIRMING THE DECISION OF THE TAX COURT, THIS COURT HAS OVERLOOKED THE CORRECT MEANING OF THE TERM "BONA FIDE"; IT HAS LIKEWISE OVERLOOKED THE PRESUMPTION OF GOOD FAITH AND HAS OVERLOOKED THE RULE WHICH REQUIRES THE TAX COURT NOT TO REJECT UNCONTRADICTED AND UNIMPEACHED EVIDENCE.**

It pointed out to both the Tax Court and this Court that there was no conflict in the record; that all the evidence was adduced by the petitioners and that the respondent had produced no evidence to overcome petitioners' case. It was also pointed out that the "presumption of law" in favor of respondent's determination of deficiencies had been overcome and that there was nothing in the record that overcame the presumption of good faith which accompanied the petitioners and their children throughout the proceedings (Petitioners' Opening Brief pp. 31-34). It was shown too that the inferences which the Tax Court drew from the uncontradicted record were erroneous and were supported only by the equally erroneous assumption that the powers of management vested in Harkness,



Sr., had not been exercised by him as an agent or fiduciary, but as an owner. It was shown, moreover, that this erroneous assumption resulted from the Tax Court's failure to give effect to the intent and good faith of the parties (Petitioners' Opening Brief pp. 58-75).

It is apparent to us from the opinion of this Court that petitioners' contentions above summarized were entirely overlooked. We believe this occurred because this Court, as well as the Tax Court, had adopted herein an erroneous definition of the term "good faith".

This Court ruled that the Tax Court found a *good faith* intent to form a partnership in the *future* and that there was not a *bona fide* intent to form a partnership in the present, that is to say, in the year 1943. This Court also ruled that these ultimate findings were supported by the record. We contend that these rulings ignore the correct meaning of the term "bona fide".

At a very early date, the Supreme Court of the United States defined this term as follows:

"*Bona fide* is a legal, technical expression and the law of Great Britain and this Country has annexed a certain idea to it. It is a term used in statutes in England, and in acts of assembly of all the states, and signifies a thing done really, with a good faith, without fraud, or deceit, or collusion or trust."

*Ware v. Hylton* (1796), 3 U.S. (3 Dall.) 196, 241, 1 L. Ed. 568, 586.



The converse of the term is bad faith, deceit, etc., and it will be noted that it contains none of the elements of *frustration* or *impossibility*.

It is clear, therefore, that if this Court and the Tax Court hold that petitioners and their children were not bona fide partners in 1943, within the correct definition of the term, then this Court and the Tax Court have plainly said that petitioners and their children entered into a fraudulent scheme designed to deceive the tax collector, and they have likewise said that the solemn agreements and conveyances between the parties were merely the means whereby the scheme was to be executed.

It is hard to believe that this Court and the Tax Court could have had the correct definition in mind because it can be gathered from what appears in the opinions that both Courts concede that petitioners' evidence has the "flavor of truth".

The Tax Court found that many legitimate business reasons dictated the decision to form the partnership. It found also that a decline in profits in the fruit packing business was anticipated, and that, in the formation of the partnership, the tax saving possibilities were only a secondary consideration (R. 253-254; 255-256). And speaking of the record, as a whole, the Tax Court said:

"\* \* \* some of the evidence is indicative of a valid family partnership \* \* \*." (R. 274.)

This Court, after having considered the record, said:

“\* \* \* the evidence leaves little room for doubt that Harkness, Sr. had determined that ultimately there should be a partnership including the children.”

And in appraising the findings and opinion of the Tax Court, this Court stated:

“The Tax Court expressed no doubt of a good faith intent to create a partnership at *some time*.”

In addition, if our memories serve us correctly, Counsel for respondent at the oral argument conceded that petitioners' witnesses had testified truthfully and that the parties had acted in good faith. His contention was that the good faith purpose of the parties had in some fashion been frustrated or defeated.

But assuming, nevertheless, that this Court had the correct meaning of the term in mind, then we submit that the tenuous inference drawn from the powers of management vested in Harkness, Sr., was insufficient to overcome the presumption of good faith. The law presumes that the business transactions of every man are done in good faith and for an honest purpose; and anyone who alleges that such acts are done in bad faith, and for a dishonest and fraudulent purpose, has the burden of showing the same. (Fraud or bad faith is never presumed, but must be established by *clear, unequivocal and convincing proof*. *Proof which merely creates a suspicion is not enough*.)

*U. S. v. California Midway Oil Co.* (D.C.S.D., Calif., 1919), 259 Fed. 343, 352, 353;

*Jones, Commentaries on Evidence*, Vol. 1, Sec. 13, pp. 99-100.

It is respectfully submitted that the inference drawn from the control of Harkness, Sr., over the business in 1943, is so weak as to amount to a suspicion, and does not amount to clear, unequivocal and convincing evidence sufficient to prove fraud. It is therefore respectfully urged that if the Court intended to use the term "bona fide" in its correct sense, it overlooked the presumption of good faith which accompanied the parties throughout these proceedings and which could not be overcome by the alleged inference drawn by the Tax Court.

We submit also that if this Court and the Tax Court really mean that the arrangement between the parties was a child of iniquity, there is a basic inconsistency between this holding and the ruling that the parties were in good faith with respect to the future. Why should the fact that the young men rendered services in subsequent years be the purifying agent that transforms a fraudulent transaction into an honest arrangement? Why could it not be said with equal logic that the young men are in reality only supervisory employees who are paid large salaries in the guise of partnership profits, and that they hold their undivided interests in the properties subject to a secret trust for the benefit of petitioners?

Frankly, we do not believe that this Court and the Tax Court meant to place the badge of fraud upon the transactions between petitioners and their



children. We believe that there was a confusion in terms; that this Court, as well as the Tax Court, found no bona fide intent only in the sense that a transaction intended to be in good faith was frustrated and defeated because the children could not work or personally exercise control over their property during the year 1943. We likewise believe that this confusion in terms results from not considering the intent of the parties as expressed in the record and from attempting to resolve the issue as to the reality of the partnership by applying the discredited "vital services-original capital" test.

Moreover, we believe that this confusion in terms caused this Court to overlook the rule which forbids the Tax Court to disregard uncontradicted evidence, particularly, when the Tax Court concedes that the testimony has "the flavor of truth", and has said nothing which would cast any doubt upon the veracity of the witnesses.

In the case of *Mayson Mfg. Co. v. Commissioner* (C.A. 6-1949), 178 F. (2d) 115, 121-122, the rule was stated as follows:

"We recognize that in the present case petitioner's evidence on the issue was not from impartial witnesses. *But, nevertheless, it was uncontradicted and was not referred to in the opinion of the Tax Court as being unworthy of belief. Under such circumstances, the failure of the Commissioner to introduce testimony supporting the deductions made by him lends considerable support to our view, gathered from other undis-*



*puted facts in the case, that the findings of the Tax Court on the issues involved are clearly erroneous and should be set aside.”* (Emphasis supplied.)

The rule is likewise well expressed in *Lawton v. Commissioner* (C.C.A. 6-1947), 164 F. (2d) 380, 384 as follows:

“We are aware, of course, that the Tax Court is not required, at all events, to believe the testimony of witnesses, or even to accept at face value documents offered in evidence, but it appears to be well settled that the fact finder *may not arbitrarily disregard undisputed and uncontradicted testimony of unimpeached persons where he has already found facts which lend a flavor of truthfulness to their assertions.*” (Emphasis supplied.)

In connection with the foregoing rule, we call attention to the comment which this Court made in its opinion with respect to the evidence relating to the years after 1943. This Court said:

“Since it was as likely to show an intent respecting future conduct as one for a present enterprise, there was no occasion for the Court to make findings thereon.”

We gather from the Court’s comment that the Court was not of the opinion that this evidence gave rise to conflicting inferences which cancelled each other, but that the Court felt that at worst this evidence was ambiguous. We submit therefore that since

the record as a whole is uncontradicted and possesses the flavor of truth, this ambiguity should have been resolved in favor of petitioners and not in favor of respondent. If this seeming ambiguity is resolved in favor of petitioners, as it should be, then there is no substantial evidence to support the findings of the Tax Court that petitioners and their children were not bona fide partners in 1943.

It is respectfully submitted that, for the reasons above set forth, a rehearing should be granted in these causes.

Dated, San Francisco, California,  
January 25, 1952.

Respectfully submitted,

PHILIP S. EHRLICH,

ALBERT A. AXELROD,

R. J. HECHT,

IRVING ROVENS,

*Attorneys for Petitioners.*

CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsed for petitioners in the above entitled cause and that in my judgment the foregoing petition for a rehearing is well founded in point of law as well as in fact and that said petition for a rehearing is not interposed for delay.

Dated, San Francisco, California,

January 25, 1952.

PHILIP S. EHRLICH,

*Of Counsel for Petitioners.*





No. 12,620

IN THE

United States Court of Appeals  
For the Ninth Circuit

---

ALFRED V. GOO,

*Appellant,*

VS.

UNITED STATES OF AMERICA,

*Appellee.*

Appeal from the United States District Court  
for the District of Hawaii.

BRIEF FOR ALFRED V. GOO, APPELLANT.

---

J. GARNER ANTHONY,

ROBERT E. BROWN,

312 Castle & Cooke Building, Honolulu 1, Hawaii,

*Counsel for Appellant.*

ROBERTSON, CASTLE & ANTHONY,

312 Castle & Cooke Building, Honolulu 1, Hawaii,

PETER A. LEE,

313 McCandless Building, Honolulu, Hawaii.

*Of Counsel.*

FILED

OCT 31 1950

PAUL P. O'BRIEN,  
CL



## Subject Index

---

	Page
Opinion below .....	1
Jurisdiction .....	1
Statement of the case .....	2
Errors relied upon .....	4
Summary of argument .....	4
Argument .....	5
I. Withdrawal of plea of guilty before sentence is a matter of right .....	5
II. Denial of appellant's motion to withdraw his plea of guilty before sentence was an abuse of discretion .....	15
Conclusion .....	25

## Table of Authorities Cited

Cases	Pages
Bergen v. United States, 145 F. (2d) 181 (C.C.A. 8th 1944) .....	6, 11, 22
Collins v. United States, 176 F. (2d) 773 (C.A. 9th 1949) ..	10, 21
Cooke v. Swope, 28 F. Supp. 492 (W.D. Wash. 1939), aff'd 109 F. (2d) 955 (C.C.A. 9th 1940) .....	7
Farnsworth v. Zerbst, 98 F. (2d) 541 (C.C.A. 5th 1938) ....	6
Farrington v. King, 128 F. (2d) 785 (C.C.A. 8th 1942) ....	7
Gleckman v. United States, 16 F. (2d) 670 (C.C.A. 8th 1926) .....	10
Hood v. United States, 152 F. (2d) 431 (C.C.A. 8th 1946)	7
Jackson v. United States, 131 F. (2d) 606 (C.C.A. 8th 1942)	7
Kercheval v. United States, 274 U.S. 220 .....	10, 20, 22
Rachel v. United States, 61 F. (2d) 360 (C.C.A. 8th 1932) ..	10, 20
Roberto v. United States, 60 F. (2d) 774 (C.C.A. 7th 1932) .....	10, 20
Scheff v. United States, 33 F. (2d) 263 (C.C.A. 8th 1929) ..	10
Stidham v. United States, 170 F. (2d) 294 (C.A. 8th 1948)	10
Swift v. United States, 148 F. (2d) 361 (C.A. D.C. 1945) .....	6, 7, 8
Taylor v. United States, 179 F. (2d) 640 (C.A. 9th 1950), and subsequent appeal dismissed 180 F. (2d) 1020 .....	14
United States v. Achtner, 144 F. (2d) 49 (C.C.A. 2nd 1944) .....	7, 8
United States v. Bayaud, 23 Fed. 721 (C.C. S.D. N.Y. 1883) .....	10, 20
United States v. Colonna, 142 F. (2d) 210 (C.C.A. 3rd 1944)	6
United States v. Denniston, 89 F. (2d) 696 (C.C.A. 2nd 1937) .....	6
United States v. Fox, 130 F. (2d) 56 (C.C.A. 3rd 1942) ..	6



# TABLE OF AUTHORITIES CITED

iii

	Pages
United States v. Harris, 160 F. (2d) 507 (C.C.A. 2nd 1947)	10
United States v. Lias, 173 F. (2d) 685 (C.A. 4th 1949)	
.....	10, 14, 21, 25
United States v. Mignogna, 156 F. (2d) 839 (C.C.A. 2nd 1946)	7, 10
United States v. Searle, 180 F. (2d) 209 (C.A. 7th 1950)	10
United States v. Western Chemical & Mfg. Co., 78 F. Supp. 983 (S.D. Cal. 1948)	24
Von Moltke v. Gillies, 161 F. (2d) 113 (C.C.A. 6th 1947)	7, 8
Von Moltke v. Gillies, 332 U.S. 708	7, 9, 11, 24
Ward v. United States, 116 F. (2d) 135 (C.C.A. 6th 1940)	6, 20

## Statutes and Rules

Crimes and Criminal Procedure:	
18 U.S.C. Sec. 3771, 3772	5
Federal Rules of Criminal Procedure:	
Rule 32(d)	7, 9, 10, 12, 13, 14, 15
Rules in Criminal Cases:	
Rule II (4)	6, 8, 11, 12

## Miscellaneous

Orfield, Procedure in Federal Criminal Cases, 2 Federal Rules Decisions 573	8
---	---



No. 12,620

IN THE  
**United States Court of Appeals**  
**For the Ninth Circuit**

---

ALFRED V. GOO,

*Appellant,*

vs.

UNITED STATES OF AMERICA,

*Appellee.*

Appeal from the United States District Court  
for the District of Hawaii.

**BRIEF FOR ALFRED V. GOO, APPELLANT.**

---

**OPINION BELOW.**

The memorandum order of the District Court denying appellant's motion to withdraw plea is unreported but appears on pages 18-29 of the record.

---

**JURISDICTION.**

By information filed in the United States District Court for the District of Hawaii on February 9, 1950 (R. 2-4), appellant was charged in three counts with willfully attempting to evade taxes in violation of

the provisions of 26 U.S.C. Section 145(b). Appellant on the same day entered plea of guilty to each of these counts (R. 5, 40). His subsequent motions to withdraw plea were denied by the District Court (R. 8, 18, 29), which entered judgment and sentence thereon against appellant on June 1, 1950 (R. 29-33). Notice of appeal was filed on June 6, 1950, pursuant to 18 U.S.C. Section 3772 and Rule 37(a) of Federal Rules of Criminal Procedure thereunder (R. 34-35).

Jurisdiction of the District Court rests on 18 U.S.C. Section 3231. Jurisdiction of this Court is invoked under 28 U.S.C. Sections 1291 and 1294.

---

### **STATEMENT OF THE CASE.**

This is an appeal from the conviction and sentence of appellant for alleged criminal violations of the Internal Revenue Code, imposed by the District Court on the basis of appellant's plea of guilty to those charges, and from the preceding order of the District Court denying appellant leave to withdraw his plea.

On or about January 10, 1950, appellant consulted counsel in regard to notification received from the Department of Justice indicating his imminent prosecution for claimed evasion of some \$7,500 in taxes (R. 81-82, 88, 103, 139). With his attorneys and bookkeeper he attended a conference on January 20th with representatives of the Bureau of Internal Rev-



enue to determine the basis of the government's accusation against him (R. 93, 141, 159, 168). At this meeting, which lasted an hour or two, they were permitted to examine appellant's books and other materials held by the government as evidence (R. 96, 143, 159-160, 169). Appellant and his attorneys conferred several times subsequently on the matters of these criminal charges and his civil tax liability (R. 96, 144, 162).

On February 9, 1950, appellant appeared in the District Court with counsel. The Assistant United States Attorney filed in open court appellant's waiver of indictment and an information charging appellant with willfully attempting to evade income and victory tax owing by him for the year 1943 and income tax owing by him and his wife for the years 1944 and 1945 (R. 2-6, 40). Upon inquiry of the court, appellant himself pleaded guilty to each of the information's three counts (R. 5, 40). After hearing statements of counsel, the court postponed for ten days its judgment and sentence with the suggestion that appellant meanwhile settle his undetermined civil tax liability to the government (R. 5, 53).

Within one week after his entry of plea, appellant terminated the services of his former attorneys and engaged his present counsel (R. 7, 100, 150).

Upon hearing for sentence held on February 20th, the District Court granted appellant's new counsel further time to ascertain and negotiate settlement of his civil liability but denied their motion to withdraw

the plea of guilty pending full investigation of the facts (R. 8, 59-60).

Appellant on March 27, 1950, filed formal motion to withdraw plea, supported by affidavits of himself, his attorneys and certified public accountant employed to audit his accounts (R. 9-15). The District Court heard and denied this motion on May 16, 1950 (R. 16-18), entering its memorandum ruling against appellant on May 31st. By judgment and sentence entered on June 1, 1950, it imposed upon appellant for each of the three counts a fine of \$1,000 and imprisonment for two years, imprisonment for the second and third counts to run concurrently (R. 30-31, 196).

---

#### **ERRORS RELIED UPON.**

(1) The District Court erred in ruling that appellant could not withdraw his plea of guilty as a matter of right prior to sentence.

(2) The District Court abused its discretion in refusing to allow appellant to withdraw his plea of guilty and in sentencing him to fine and imprisonment on the basis of that plea.

---

#### **SUMMARY OF ARGUMENT.**

Under Rule 32(d) of Federal Rules of Criminal procedure and the federal statute authorizing those Rules, a defendant has the right to withdraw his plea

of guilty at any time prior to sentence. Even if allowance of such withdrawal of plea before sentence lay within the discretion of the District Court, leave should be granted upon a showing of mistake, fear or other influence causing the defendant to plead guilty when he may have any defense at all. This appellant showed such grounds justifying withdrawal of his plea.

---

### ARGUMENT.

#### I. WITHDRAWAL OF PLEA OF GUILTY BEFORE SENTENCE IS A MATTER OF RIGHT.

At the outset, we concede that this proposition rests on little authority other than the language of the Federal Rules.

These rules were promulgated by the Supreme Court pursuant to authority conferred by federal statute.<sup>1</sup> This enabling legislation leaves no doubt as to the solicitude of Congress for an accused person, who has entered a plea of guilty, by expressly providing:<sup>2</sup>

This section shall not give the Supreme Court power to abridge the right of the accused to apply for withdrawal of a plea of guilty, if such application be made within ten days after entry of such plea, and before sentence is imposed.

---

<sup>1</sup>Sections 3771 and 3772 of Title 18, United States Code, Crimes and Criminal Procedure, effective September 1, 1948 and re-enacting substantially the provisions of former 18 U.S.C. Sections 687 and 688.

<sup>2</sup>18 U.S.C. Section 3772, Procedure after verdict.



We do not contend that this provision grants or preserves the right to withdraw a plea of guilty within its prescribed limitations rather than the bare right to apply therefor, although such construction would doubtless be permissible as a matter of first impression. Judicial interpretation has been otherwise, holding that the statute gives no absolute right to withdraw a plea but deals merely with the limit of time within which application to withdraw may be filed.<sup>3</sup>

Like effect was given to the rule first adopted under that statute. This rule provided:<sup>4</sup>

A motion to withdraw a plea of guilty shall be made within ten (10) days after entry of such plea and before sentence is imposed.

Under this rule it was consistently held that withdrawal of a plea of guilty, even when requested by motion within ten days after entry of such plea and before sentence, was not a matter of right, but that allowance thereof lay within the sound discretion of the trial court.<sup>5</sup> Moreover, the rule's limitation upon time for filing such motion was given jurisdictional

---

<sup>3</sup>*United States v. Colonna*, 142 F. (2d) 210 (C.C.A. 3d, 1944); *Farnsworth v. Zerbst*, 98 F. (2d) 541 (C.C.A. 5th, 1938).

<sup>4</sup>Rule II (4), Rules in Criminal Cases effective September 1, 1934;  
292 U.S. 661, 662.

<sup>5</sup>*Bergen v. United States*, 145 F. (2d) 181 (C.C.A. 8th, 1944); *United States v. Colonna*, *supra*; *Farnsworth v. Zerbst*, *supra*; *United States v. Denniston*, 89 F. (2d) 696 (C.C.A. 2d, 1937); *cf. United States v. Fox*, 130 F. (2d) 56 (C.C.A. 3d, 1942); *Ward v. United States*, 116 F. (2d) 135 (C.C.A. 6th, 1940); *see Swift v. United States*, 148 F. (2d) 361 (C.A.D.C. 1945).



effect. Whether the motion was made more than ten days after plea but before sentence,<sup>6</sup> or less than ten days after plea but following sentence,<sup>7</sup> it was dismissed as tardy, to the same effect as though filed more than ten days after plea and after sentence.<sup>8</sup>

In adopting the new<sup>9</sup> Federal Rules of Criminal Procedure, however, the Supreme Court clearly implemented that legislative concern for the rights of an accused. It differentiated between withdrawal of plea of guilty before sentence and after sentence by providing in Rule 32(d):

*Withdrawal of Plea of Guilty.* A motion to withdraw a plea of guilty or of nolo contendere may be made only before sentence is imposed or imposition of sentence is suspended; but to correct manifest injustice the court after sentence may set aside the judgment of conviction and permit the defendant to withdraw his plea.

It must be noticed that the above rule contains two separate and distinct clauses, the first relating to

---

<sup>6</sup>*Von Moltke v. Gillies*, 161 F. (2d) 113 (C.C.A. 6th, 1947), *rev'd on other grounds* 332 U.S. 708 (1948) (motion ten months after plea);

*Hood v. United States*, 152 F. (2d) 431 (C.C.A. 8th, 1946) (motion four weeks after plea);

*United States v. Achtner*, 144 F. (2d) 49 (C.C.A. 2d, 1944) (motion twelve days after plea).

<sup>7</sup>*Jackson v. United States*, 131 F. (2d) 606 (C.C.A. 8th, 1942) (motion one week after plea).

<sup>8</sup>*United States v. Mignogna*, 157 F. (2d) 839 (C.C.A. 2d, 1946) (motion seven months after plea and sentence);

*Swift v. United States*, *supra* note 5 (motion more than one year after plea and sentence);

*Farrington v. King*, 128 F. (2d) 785 (C.C.A. 8th, 1942);

*Cooke v. Swope*, 28 F. Supp. 492 (W.D. Wash., 1939), *aff'd* 109 F. (2d) 955 (C.C.A. 9th, 1940).

<sup>9</sup>Effective March 21, 1946.

withdrawal of plea before sentence and the second dealing with such withdrawal after conviction and sentence. These provisions, when read against the backdrop of the pre-existing rule and its settled construction, manifest an intention to accomplish more than mere enlargement of the time for filing a motion to withdraw a plea of guilty.

Historically, the harshness heretofore noted in Rule II (4) had evoked much criticism of the courts which were constrained to apply it according to its terms.<sup>10</sup> Professor Orfield, speaking in 1942 as a member of the Advisory Committee on Rules of Criminal Procedure of the Supreme Court, commented as follows:<sup>11</sup>

The present Rule II (4) provides that a motion to withdraw a plea of guilty must be made within ten days after entry of such plea. Is not this an undue hardship on the defendant, and should we not adopt the rule now prevalent in many states which permits withdrawal of the plea at any time before sentence?

That authority also remarked<sup>12</sup> that Section 230 of the American Law Institute Code of Criminal Procedure (1930) goes even further and permits setting aside of a judgment so that the plea may be withdrawn. Apparently, as observed by the Court of Appeals for the Eighth Circuit,<sup>13</sup> he expressed the

---

<sup>10</sup>See *Von Moltke v. Gillies*, *supra* note 6, 161 F. (2d) at 116; *Swift v. United States*, *supra* note 5, 148 F. (2d) at 362; *United States v. Achtner*, *supra* note 6, 144 F. (2d) at 52.

<sup>11</sup>Orfield, *Procedure in Federal Criminal Cases*, 2 F.R.D. 573, 577.

<sup>12</sup>[See] 2 F.R.D. at 577, note 16.

<sup>13</sup>See *United States v. Achtner*, *supra*, 144 F. (2d) at 52.

views of the Advisory Committee which recommended a substantially more liberal rule. It seems likely that the Committee in recommending the new rule, and the Supreme Court in adopting it,<sup>14</sup> acted upon these two suggestions of Professor Orfield by incorporating them respectively in the first and second clauses of Rule 32(d).

Grammatically, also, the new rule evidences a clear intention by the rule-making body to place withdrawal of a plea of guilty before sentence on a different basis than subsequent withdrawal. Had the Supreme Court desired to effectuate only a narrow purpose of enlarging time within which to present a motion for withdrawal of plea, it could easily have done so by means of one inclusive clause without resort to separate clauses relating to the two chronological stages of the criminal proceeding. It chose the latter rather than the simpler form of expression. It did so advisedly, upon the recommendation of a committee of eminent members of both bench and bar. Moreover, it specified a judicial standard to guide the District Court in permitting withdrawal of plea after sentence but imposed no such limitation upon withdrawal before sentence.

Clearly a defendant now has no unqualified right after conviction and sentence to withdraw his plea of guilty. Allowance of his motion to do so is a matter of discretion to the trial court in order to

---

<sup>14</sup>Mr. Justice Black in *Von Moltke v. Gillies*, 332 U.S. 708, 718 note 4, commented that the former rule had been liberalized by Rule 32(d).



*correct manifest injustice.* That standard for the court's exercise of discretion in cases after sentence is uniformly held, in decisions under the second clause of Rule 32(d), to require of the convicted defendant a showing of some reason why the judgment should not stand against him—a reason amounting to a fraud or imposition upon him, or a misapprehension of his rights, making it manifestly just and fair to give him the privilege to substitute pleas.<sup>15</sup>

This same test of “manifest injustice” likewise governed the granting or denial of any motion to withdraw a plea of guilty prior to 1934.<sup>16</sup> On the subject of withdrawal of plea, the Court of Appeals for the Seventh Circuit stated:<sup>17</sup>

If such a plea is inadvisably made, or is contrary to the truth, the accused should not be held strictly to his plea. He should be, and so far as our observation goes, he is, permitted to change the plea.

And dictum of the Supreme Court in *Kercheval v. United States*,<sup>18</sup> wherein the District Court had al-

---

<sup>15</sup>*United States v. Searle*, 180 F. (2d) 209 (C.A. 7th, 1950);  
*Collins v. United States*, 176 F. (2d) 773 (C.A. 9th, 1949);  
*United States v. Lias*, 173 F. (2d) 685 (C.A. 4th, 1949);  
*Stidham v. United States*, 170 F. (2d) 294 (C.A. 8th, 1948);  
*United States v. Harris*, 160 F. (2d) 507 (C.C.A. 2d 1947);  
*United States v. Mignogna*, *supra* note 8.

<sup>16</sup>*Rachel v. United States*, 61 F. (2d) 360 (C.C.A. 8th, 1932);  
*Roberto v. United States*, 60 F. (2d) 774 (C.C.A. 7th, 1932);  
*Scheff v. United States*, 33 F. (2d) 263 (C.C.A. 8th, 1929);  
*Gleckman v. United States*, 16 F. (2d) 670 (C.C.A. 8th, 1926);

*United States v. Bayaud*, 23 Fed. 721 (C.C. S.D. N.Y. 1883).

<sup>17</sup>*Roberto v. United States*, *supra*, 60 F. (2d) at 775.

<sup>18</sup>274 U.S. 220, 223 (1927).



lowed withdrawal of the defendant's plea of guilty and the sole issue on appeal was the admissibility of the plea as evidence upon trial, has become the rule of decision applicable whenever the motion to withdraw plea is addressed to the discretion of the trial court:

“Out of just consideration for persons accused of crime, courts are careful that a plea of guilty shall not be accepted unless made voluntarily after proper advice and with full understanding of the consequences \* \* \* But, on timely application, the court will vacate a plea of guilty shown to have been unfairly obtained or given through ignorance, fear or inadvertence. Such an application does not involve any question of guilt or innocence. \* \* \* The court in the exercise of its discretion will permit one accused to substitute a plea of not guilty and have a trial if for any reason the granting of the privilege seems fair and just.<sup>19</sup>

The essence of those decisions<sup>20</sup> under former Rule II(4) was stated succinctly by the court in *Bergen v. United States*,<sup>21</sup> as follows:

We think it may be gathered from all of the cases that an accused is entitled to withdraw a plea of guilty if it fairly appears that he was in ignorance of his right and of the consequence of his act, or if it appears that the plea was made under some mistake or misapprehension. The

---

<sup>19</sup>Quoted in part in *Von Moltke v. Gillies*, *supra*, 332 U.S. at 719, as the basis for determining such motions under Rule II (4).

<sup>20</sup>Cases cited in note 5 *supra*.

<sup>21</sup>145 F. (2d) 181, 187 (C.C.A. 8th, 1944).

withdrawal should not be denied where a proper showing for its allowance is made, merely because the defendant on a trial might or probably would be found guilty. While the burden is on the accused to show cause for the change of his plea, the court's discretion should be exercised liberally, so as to promote the ends of justice and to safeguard the life and liberty of the accused, especially where the defendant is without the advice of counsel and his motion is seasonably made. And, in any case, the motion should not be denied where it is evident that the ends of justice would best be served by granting it.

It is thus seen that the principle, that the trial court's discretion should be exercised by granting a timely motion for withdrawal of plea of guilty "if for any reason the granting of the privilege seems fair and just", was brought forward from the earlier decisions to govern those cases within Rule II(4); and it has since been carried on to apply in cases within the second clause of Rule 32(d). In short, the standard by which the court must exercise its discretion, in ruling upon such motions made after sentence, has been thoroughly explored over the years and is now crystallized. The showing of "manifest injustice" required to support any such motion made after sentence has been fairly defined by judicial decision.

But what is the criterion of decision in those cases falling within the first clause of Rule 32(d), of motions to withdraw plea of guilty made before sentence is imposed? Are those motions addressed to the sound

discretion of the court; and, if so, does the same standard order its exercise of discretion as in cases of like motions made after sentence?

Significantly, the Supreme Court prescribed no such standard by the first clause of its new rule. It did not qualify the right to withdraw a plea of guilty by requiring the moving defendant to show "manifest injustice" in such cases.

The implication is clear: Rule 32(d) leaves no residuum of discretion in the District Court by which to deny any motion made before sentence to withdraw a plea of guilty; it places upon the defendant no onus of persuading the District Court that the granting of such motion would be fair and just; and it allows him, through the medium of such motion, to withdraw his plea of guilty as a matter of right.

Under any other construction given the first clause of Rule 32(d), that clause loses all independent significance and becomes a mere preface to the second clause, modified by the latter's restriction upon withdrawal of plea. So, then, must the separation of thought apparent in both punctuation and chronological context of the rule be disregarded. We are unwilling to ascribe to the Supreme Court the ambiguity in expression, prolixity, and ineptness of draftsmanship implicit in such an interpretation of two simple and perfectly harmonious clauses.

Construed together as integral yet distinct sections of the same rule, they convey the substantive meaning that the defendant before imposition of sentence



is entitled without limitation to withdraw his plea of guilty on motion; and that after sentence, he is so entitled upon motion supported by a showing of some reason why his substitution of pleas is fair and just.

Support is given this view by the absence of judicial opinion in point. Search of the reports reveals no decision interpreting the first clause of Rule 32(d), all of the reported cases<sup>22</sup> dealing with motions made after conviction and sentence and applying—quite properly—the second clause of the rule. In fact, several of the decisions<sup>23</sup> relied on by the court below (R. 22) in rejecting this construction of Rule 32(d) do not even consider or make reference to that rule. Undoubtedly this absence of decisions construing the first clause of the rule exists because District Courts uniformly grant (as a matter of course) the accused's motion prior to sentence, and that action is not reviewable.<sup>24</sup>

We submit that appellant's motions to withdraw his plea of guilty, twice duly made before imposition of sentence, should have been granted as a matter of right under Rule 32(d); and that the District Court erred in denying those motions on the ground that their disposition rested in the area of judicial discretion.

---

<sup>22</sup>Cases cited note 15 *supra*.

<sup>23</sup>*Taylor v. United States*, 179 F. (2d) 640 (C.A. 9th, 1950), and subsequent appeal dismissed 180 F. (2d) 1020.

<sup>24</sup>*United States v. Lias*, *supra* note 15, 173 F. (2d) 685.



## II. DENIAL OF APPELLANT'S MOTION TO WITHDRAW HIS PLEA OF GUILTY BEFORE SENTENCE WAS AN ABUSE OF DISCRETION.

Assuming *arguendo* that a motion made by a defendant before sentence to withdraw his plea of guilty is addressed to the discretion of the court, under Rule 32(d), still the record shows an abuse of discretion in the denial of appellant's motion.

The affidavits (R. 9-15) filed by appellant in support of his motion to withdraw plea speak for themselves.

Appellant himself alleged his unfamiliarity with the court's criminal procedure when he appeared in court on February 9, 1950 (R. 9); that at the time he entered his plea of guilty, following advice of his then counsel, no audit had been made of his books to determine whether he owed the taxes claimed in the information (R. 9-10); and that he pleaded guilty through fear, ignorance, confusion and expediency (R. 10). He further alleged that subsequent to pleading he felt he had been mistaken and engaged new counsel (R. 9); that his attorneys hired certified public accountants to investigate his tax liability (R. 10); that an incomplete audit of his books had revealed factors which eliminated his tax liability for 1945 and reduced by an indeterminate amount that liability for 1944, two of the years in question (R. 10); and that he did not know whether or not his residual tax liability, if any, constituted fraud (R. 10). He also set forth that claimed loss of his cancelled checks by the United States Internal Revenue

agents prevented verification that certain refunds from commission houses, asserted by those agents to be unreported income, were actually not taxable (R. 10-11). In these circumstances of insufficient information, he concluded, his attorneys did not and could not advise him to plead guilty (R. 11).

Affidavits of appellant's attorneys and accountant, who investigated his tax liability, substantiated his statements that apparent factors not credited by the Internal Revenue officials reduced materially that liability for 1944 and 1945 (R. 12-14). On the basis of this investigation, his attorneys stated that they could not advise appellant to plead guilty or allow that plea to stand (R. 15).

The facts thus presented, which were not denied by affidavit or other document of the appellee, may be segregated into two general grounds justifying appellant's withdrawal of his plea of guilty. First, although represented by counsel prior to and at the time of pleading, he entered his plea inadvisedly as a result of fear, ignorance, confusion and expediency. Second, neither appellant nor his counsel knew the true state of facts forming the basis of the government's charges against him, and he therefore pleaded in mistake and misapprehension of those facts and their consequences. Little light was shed on the latter ground at the hearing of the motion, for the court announced that it considered the matters relating to actual tax liability—which appellant offered to show by testimony of the auditing accountant—irrelevant to the motion (R. 78-79, 101). Ap-

pellant's showing was therefore confined to his own testimony (R. 80-101).

Appellant acknowledged consulting his attorney several times before entering his plea. In discussing on one of these occasions the amount of tax claimed by the government, some \$7,500, he protested that he owed nothing like that sum. To this his attorney reportedly told him he was guilty just the same even if he owed one dollar, and that it was best to plead guilty (R. 82-98). Appellant stated that his attorney advised him to plead guilty (R. 84, 87, 97), that he had no other alternative, that if he argued the court would give him a long-term prison sentence, and that the best thing for him was to keep his mouth shut and say nothing (R. 85, 87). He had never been in a court room or had any knowledge of criminal proceedings prior to this case (R. 84, 85); and since he had employed counsel to advise him, he followed that advice (R. 87).

Thus appellant explained the reasons for entering his plea. It was induced in part by fear—fear of long imprisonment if he contested the government's charges or disputed the amount of tax claimed; in part by ignorance—ignorance of the technical elements constituting the crimes with which he was charged, of court procedure and the presumption of innocence which protects every citizen until disproved, and of the legal inaccuracy of his attorney's opinion that he was guilty if he owed \$1 or \$7,500 in taxes; and in part by expediency—being



advised to plead guilty and say nothing. An additional element of confusion arose in appellant's mind through the injection into this criminal proceeding of matters relating to his civil liability for taxes, as he did not at the time appreciate the difference between civil and criminal liability (R. 100-101).

The government sought to refute these subjective misconceptions in the mind of appellant, which motivated him to plead guilty, by introducing the testimony of his former attorneys as to what had passed between them and their client.

One denied advising appellant to plead guilty, although stating in the same breath that it was his suggestion (R. 143, 148). His associate, however, admitted that they—the attorneys—advised appellant to plead guilty, told him that it would be to his advantage not to put the government to the expense of trying the case (R. 135, 160-162). This much is certain, that these attorneys advised appellant over a period of some weeks, and nowhere do they suggest that they advised any plea other than guilty.

On the face of the record it comes to this: one of appellant's former attorneys corroborates his statement of the advice he received, while the other denies it. There is, to say the least, a strong inference that somewhere in the course of his conferences with his attorneys appellant gained the belief that he had no alternative but to plead guilty, that resistance of the charges against him would be futile and only result in a much harsher sentence than if



he said nothing. Precise words spoken between attorney and client are not in issue here, the sole inquiry relating to appellant's state of mind when he entered his plea.

Perusal of the record can leave no doubt, moreover, that at the time they were advising their client regarding the government's impending prosecution, appellant's former counsel were singularly uninformed of the taxes which he had allegedly attempted to evade. They made no investigation of his books and records, employed no accountants to examine into his tax liability, made no recommendation that he procure such an audit, and did not even talk to his bookkeeper until after the plea; in fact, despite appellant's disclaimer of the tax obligation asserted by the government, they made no effort whatsoever to ascertain independently the amount of his unpaid taxes, if any (R. 83). They accepted without reservation the deficiencies represented by Internal Revenue agents, apparently content to glance over a few cancelled checks and pages of appellant's books during one brief conference (R. 95-96, 143, 159-160, 168-170). While this inspection may have satisfied them that the taxes claimed were actually owing, it did not satisfy appellant, who engaged new counsel. That occurred after he had pleaded to the information, of course; but only then, after new counsel had partially developed the true status of his tax liability, did he appreciate the enormity of his mistake in both fact and law.

Nothing in the record impugns appellant's testimony that, had he known about his income tax what he learned subsequent to the date of pleading, he would not have entered a plea of guilty in this case (R. 85).

If the granting or denial of a motion to withdraw a plea of guilty before sentence be deemed to lie within the discretion of the District Court, the only question for decision here is whether this showing made by appellant was sufficient to warrant allowance of his change of plea. That sufficiency must be measured against the several criteria of "manifest injustice" established by the decisions, heretofore reviewed.<sup>25</sup> To recapitulate briefly, an accused will be allowed to withdraw such plea if—

given through ignorance, fear or inadvertence<sup>26</sup>  
or—

made under any misapprehension or mistake<sup>27</sup>  
or—

inadvisedly made, or is contrary to the truth<sup>28</sup>  
or—

some reason existing when it was entered, but for which he would not have entered the plea<sup>29</sup>  
or—

entered because of misunderstanding of its effect or because of misrepresentation.<sup>30</sup>

---

<sup>25</sup>See Part I *supra*.

<sup>26</sup>*Kercheval v. United States, supra*, 274 U.S. at 224.

<sup>27</sup>*United States v. Bayaud, supra*, 23 Fed. at 722.

<sup>28</sup>*Roberto v. United States, supra*, 60 F. (2d) at 775.

<sup>29</sup>*Rachel v. United States, supra*, 61 F. (2d) at 362.

<sup>30</sup>*Ward v. United States, supra*, 116 F. (2d) at 137.

The effect of the decisions bearing on this subject is well summarized by the Court of Appeals for the Fourth Circuit, as follows:<sup>31</sup>

The least surprise or influence causing a defendant to plead guilty when he has any defense at all should be sufficient grounds for permitting a change of plea from guilty to not guilty. Leave should ordinarily be given to withdraw a plea of guilty if it was entered by mistake or under a misconception of the nature of the charge; through a misunderstanding as to its effect; through fear, fraud, or official misrepresentation; was made involuntarily for any reason; or even where it was entered inadvisedly, if any reasonable ground is offered for going to the jury.

We submit that appellant made a clear showing of justification for his change of plea within the above principles. From the evidence presented there is good reason to believe that his plea of guilty was actuated in considerable degree by fear, ignorance, misapprehension, mistake and misunderstanding. Certain it is that he pleaded inadvisedly, without proper investigation of the facts by either himself or counsel, and that the facts and law as he subsequently understood them render the plea contrary to the truth. As Judge Stephens of this Court has so recently stated concerning a plea of guilty:<sup>32</sup>

---

<sup>31</sup>*United States v. Lias*, *supra* note 15, 173 F. (2d) at 688, quoting with approval 14 Am. Jur. 961-962.

<sup>32</sup>Dissenting in *Collins v. United States*, *supra* note 15, 176 F. (2d) at 777.



One who so pleads may be bound thereby, but it is imperative that the chosen course of action be undertaken with full knowledge of the facts and probable consequences \* \* \*

That requisite knowledge of the facts at the time of pleading was undeniably lacking here. Such defect in comprehension, alone, constitutes sufficient reason why "the granting of the privilege seems just and fair".<sup>33</sup>

One serious consideration remains. The record makes plain that the District Court, in deciding the motion to withdraw plea, felt that its dignity had been affronted by a telephone call on behalf of appellant and an endeavor by appellant to speak personally about his case, events which reportedly occurred between pleading and the time when present counsel took up his defense (R. 20, 29, 57, 186). What implications the court attached to these extra-judicial matters were shown by its remark that the motion would have "smelled sweeter" in their absence (R. 29). We cannot accept such characterization of this motion as proper or justified by the circumstances. For all that appears in the record, the incidents to which the court referred were the efforts of some well-meaning but misguided friend. But whether or not the court below was justly exercised, such factors should not have influenced the court in exercising its discretion. This resembles the situation in *Bergen v. United States*,<sup>34</sup> wherein the appellate court took

---

<sup>33</sup>See *Kercheval v. United States*, *supra*, 274 U.S. at 224.

<sup>34</sup>145 F. (2d) 181 (C.C.A. 8th, 1944).



notice that, in denying a similar motion to withdraw plea of guilty—

The court was clearly influenced in his conclusion by information which had reached him of conversations between the accused and the marshal which gave support to the idea that the accused had changed his mind by reason of influence brought to bear upon him by other defendants in similar cases pending in the court.<sup>35</sup>

Since that knowledge acquired outside the hearing was not evidence or relevant to the motion, the question being neither the probable guilt of the accused nor what caused him to change his mind, judgment denying the motion was reversed.

In ruling that appellant had provided no basis upon which it could exercise its discretion in favor of the motion (R. 29), the court below was thus influenced in immeasurable degree by matters neither evidential nor relevant. Such influence, reacting upon the mind of the court to discredit the sufficient reasons shown by appellant for his change of plea, led it to an abuse of discretion in denying the motion and predicating judgment and sentence upon appellant's plea of guilty.

The liberal tenor of decisions granting leave to withdraw a plea after conviction and sentence leave no doubt that the court's action, with respect to withdrawal of plea *before* sentence, amounted to abuse of discretion in these circumstances—if, indeed, the

---

<sup>35</sup>*Id.* at 188.

trial court has discretion in such a ~~moment~~ <sup>motion</sup>. In one such case,<sup>36</sup> the court not only allowed the defendant after judgment and sentence to withdraw a plea of *nolo contendere* but refunded those fines which remained in the court's registry. In another, the Supreme Court acknowledged the great reluctance with which courts customarily act upon a plea of guilty, quoting recognized authorities as follows:<sup>37</sup>

Since a plea of guilty is a confession in open court and a waiver of trial, it has always been received with great caution. It is the duty of the court to see that the defendant thoroughly understands the situation and acts voluntarily before receiving it.

And further:<sup>38</sup>

Upon a simple and plain confession, the court hath nothing to do but to award judgment; but it is usually very backward in receiving and recording such confession, out of tenderness to the life of the subject; and will generally advise the prisoner to retract it and plead to the indictment.

Appellant seeks no judgment of acquittal in this proceeding. He only asks adherence to Blackstone's precept, that he be allowed to retract his "confession" and plead anew to the information because of mis-

<sup>36</sup>*United States v. Western Chemical & Mfg. Co.*, 78 F. Supp. 983 (S.D. Cal. 1948).

<sup>37</sup>See *Von Moltke v. Gillies*, *supra*, 332 U.S. at 719, note 5, quoting with approval Orfield, *Criminal Procedure from Arrest to Appeal* (1947) at 300.

<sup>38</sup>*Ibid.* quoting 4 Blackstone, Commentaries at \*329.

conceptions entertained when he first pleaded. On this very basis another court, demonstrating that liberality of discretion which pervades treatment of this subject by the federal judiciary, allowed withdrawal of plea after sentence, saying:<sup>39</sup>

If the defendant had that bona fide belief in his mind and if that belief was a controlling factor in causing him to enter a plea of guilty, the court has to take that belief into consideration, irrespective of the kind of information upon which it was founded. In any event, my conscience will not permit me to be a party to sending a man to the penitentiary upon a plea of guilty when he insists that he did not commit the acts constituting guilt.

That rationale, applied to the circumstances here disclosed, should have moved the discretion of the court below to permit withdrawal of appellant's plea of guilty.

---

### CONCLUSION.

For the foregoing reasons, we submit that the order and judgment appealed from should be revealed, the sentence imposed upon appellant vacated, and this cause remanded to the District Court for the District of Hawaii with directions to allow appellant to with-

---

<sup>39</sup>Baker, District Judge, quoted by the Circuit Court in *United States v. Lias*, *supra* note 15, 173 F. (2d) at 687.

draw his plea of guilty and to enter a plea of not guilty therein.

Dated, Honolulu, Hawaii,  
October 27, 1950.

Respectfully submitted,  
J. GARNER ANTHONY,  
ROBERT E. BROWN,  
*Counsel for Appellant.*

ROBERTSON, CASTLE & ANTHONY,  
PETER A. LEE,  
*Of Counsel.*



No. 12,620

IN THE  
**United States Court of Appeals**  
**For the Ninth Circuit**

---

ALFRED V. GOO,

VS.

UNITED STATES OF AMERICA,

*Appellant,*

*Appellee.*

**Appeal from the United States District Court  
for the District of Hawaii.**

**BRIEF FOR APPELLEE.**

---

**RAY J. O'BRIEN,**

United States Attorney, District of Hawaii,

**HOWARD K. HODDICK,**

Assistant United States Attorney, District of Hawaii,

Honolulu, T. H.,

**FRANK J. HENNESSY,**

United States Attorney,

Post Office Building, San Francisco 1, California,

*Attorneys for Appellee*

FILED

1950

PAUL P. O'BRIEN,



## Subject Index

---

	Page
Opinion below .....	1
Jurisdiction .....	1
Statement of the case.....	2
Summary of argument .....	13
Argument .....	13
I. Defendant is not entitled to withdraw his plea of guilty prior to sentence as a matter of right.....	13
II. The District Court did not abuse its discretion by denying the appellant's motion to withdraw his plea..	20
Conclusion .....	24

## Table of Authorities Cited

Cases	Pages
Bergen v. United States, 145 F. (2d) 181.....	15, 21
Collins v. United States, 176 F. (2d) 773.....	20
Cooke v. Swope, 109 F. (2d) 955.....	15, 21
Cooper v. United States, 5 F. (2d) 824.....	9
Farnsworth v. Zerbst, 98 F. (2d) 541.....	15, 20
Farrington v. King, 128 F. (2d) 785.....	15
Gleckman v. United States, 16 F. (2d) 670.....	21
Hunt v. Blackburn, 128 U.S. 464.....	9
Jackson v. United States, 131 F. (2d) 606.....	21
Kercheval v. United States, 274 U.S. 220.....	20
Manning v. Seeley Tool and Box Company, 338 U.S. 561....	23
Roberto v. United States, 60 F. (2d) 774.....	21
Scheff v. United States, 33 F. (2d) 263.....	21
Stidham v. United States, 170 F. (2d) 294.....	20
Swift v. United States, 148 F. (2d) 361.....	15, 16
Taylor v. United States, 179 F. (2d) 640.....	6, 20
United States v. Achtner, 144 F. (2d) 49.....	15, 16
United States v. Bayaud, 23 Fed. 721.....	21
United States v. Colonna, 142 F. (2d) 210.....	15, 22
United States v. Denniston, 89 F. (2d) 696.....	15
United States v. Fox, 130 F. (2d) 46.....	15, 21
United States v. Harris, 160 F. (2d) 507.....	20, 22
United States v. Lias, 173 F. (2d) 685.....	20
United States v. Mignogna, 157 F. (2d) 839.....	15, 20
United States v. Norstrand Corporation et al., 168 F. (2d) 481 .....	16, 22, 23



## TABLE OF AUTHORITIES CITED

iii

	Pages
United States v. Searle, 180 F. (2d) 209.....	6, 20
Von Moltke v. Gillies, 161 F. (2d) 113.....	16
Ward v. United States, 116 F. (2d) 135.....	15, 21

### Statutes

Act of March 8, 1934, Ch. 49, 48 Stat. 399.....	13, 14
Act of June 29, 1940, Ch. 445, 54 Stat. 688, 18 U.S.C. 687...	16

### Miscellaneous

Federal Rules of Criminal Procedure, Second Preliminary Draft, February 1944, U.S. Government Printing Office, Washington, D.C. ....	18
Federal Rules of Criminal Procedure with Notes and Proceedings, New York University School of Law, 1946.....	16, 19
2 Federal Rules Decisions 573.....	16



No. 12,620

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

---

ALFRED V. GOO,

vs.

UNITED STATES OF AMERICA,

*Appellant,*

*Appellee.*

**Appeal from the United States District Court  
for the District of Hawaii.**

**BRIEF FOR APPELLEE.**

---

**OPINION BELOW.**

The memorandum order of the District Court denying appellant's motion to withdraw his plea of guilty is reported in 10, Federal Rules Decisions at page 333 and also appears on pages 18-29 of the record.

---

**JURISDICTION.**

Section 3231 of Title 18, United States Code, confers jurisdiction upon the Court below; and this Court has jurisdiction under Sections 1291 and 1294 of Title 28, United States Code.

**STATEMENT OF THE CASE.**

The history of this case has been accurately related by the Honorable J. Frank McLaughlin, Judge, United States District Court for the District of Hawaii, in his memorandum ruling denying the appellant's motion to change his plea. That ruling, which was recorded in 10, Federal Rules Decisions at page 333, and appears in the record on pages 18-29, is quoted herein with the addition of references to pertinent portions of the record, as the appellee's statement of the case (the appellant is referred to as the defendant throughout the ruling):

(Title of District Court and Cause.)

**MEMORANDUM RULING UPON MOTION  
FOR CHANGE OF PLEA, RULE 32,  
F.R.C.R.P.**

On February 9, 1950, the defendant, represented by two attorneys, Harry Hewitt, Esq., and John Alexander, Esq., of the firm of Hewitt & Alexander, appeared in Court, and when the Government announced its desire to file three felony charges against the defendant in the form of an information (R. 39) the defendant waived his constitutional right and consented to the filing of the charges in that form (R. 39, 40).

Immediately thereafter defense counsel informed the Court that the defendant waived reading of the information, and was ready to plead (R. 40). As will appear infra, the defendant and his attorneys had had for some time in advance a copy of the information (R. 144). Thereupon the defendant arose and when asked by the presiding judge regarding his plea as to each count,



the defendant replied as to each count that he was guilty (R. 40).

The three pleas were recorded and the defendant adjudged guilty on each charge (R. 32, 40).

The Court then called upon the Government for a statement of the facts, after which it gave the defendant an opportunity to be heard. Through his attorney, the defendant stated he had no excuses or explanations to offer. The defendant himself remained silent (R. 41-55).

A pre-sentence investigation was ordered by the Court, the due date of which was set as February 20, 1950 (R. 53). At the same time the Court stated that the defendant might do well to consider during the interval the matter of discharging his civil liability (R. 52-53). The Court admonished the defendant, however, that it should be recognized that this judge usually sent tax dodgers to prison (R. 47) and that payment of the taxes and penalties on the civil side was not to be taken as an assurance that the defendant would not be sentenced to prison (R. 52, 53). The defense represented that it would, pending the arrival of the date set for sentence, look into the civil tax aspects of the case (R. 55).

Within a few days, the defendant in person, without either of his attorneys, appeared in this Judge's chambers desirous of seeing the Judge about his case. His request was refused. Still a bit later the Court received a telephone call from a friend who had been requested to see if he could intercede in the defendant's behalf. The Court refused to listen (R. 57).

Within a day or so the defendant discharged his attorneys, and they were excused by the Court.

The Court was then notified that Attorney Peter Lee and Attorney Garner Anthony, of the firm of Robertson, Castle & Anthony, would enter appearances for the defendant, and the Court consented to the new attorneys' assuming the responsibility for defendant's presence in Court on the date scheduled for sentence (R. 7-8).

On that date, February 20, 1950, the new attorneys appeared in Court with the defendant and requested (1) that the defendant be allowed to withdraw his pleas and (2) that since the attorneys had only recently been called into the case, time to check into the matter of the defendant's civil liability (R. 55). The first request was denied (R. 60), while the second was granted to March 13, 1950 (R. 59), and the prior admonition of the Court as to its customary type of sentence in a tax case was repeated (R. 57).

Before the arrival of the new date for sentence, the defendant, acting through his attorney, Alfred L. Castle, represented that it was essential that more time be granted as the civil liability question required that the defendant employ an accountant to make an audit, especially since the Government had lost some of defendant's canceled checks. The United States Attorney consenting, more time was granted to March 27, 1950 (R. 16).

Near the expiration of this third period of time to consider payment of the civil liability, Attorneys Anthony and Lee represented that there had been turned up a \$23,000 carry back item of loss which might result in there being no tax for the years 1946 and possibly 1945 and 1944, but that the Government would not accept it; hence more time was again needed. Having from the outset

directed the Government to cooperate with the defendant if he was disposed to settle his civil liability, the Court stated it would grant more time if the Government agreed. Assistant United States Attorney Ingman, acting in the absence of Assistant Hoddick who handled the case, said he would confer with the Internal Revenue people and report. This he did, reporting that there was no sense to granting still more time, and its reasons relating to the \$23,000 matter, and others, would gladly be recited at a conference with defendant's counsel.

The Court directed that defendant's counsel Anthony be telephoned and notified of the Government's report. This was done by Assistant United States Attorney Richardson, to whom Mr. Anthony abruptly stated that there was no point to a conference to hear the Government's reasons, and that therefore he would proceed to file a motion.

The motion turned out to be the one now under consideration, a motion to withdraw the pleas of guilty and to plead anew as not guilty. The motion was accompanied by an affidavit of the defendant, Attorney Castle, the defendant's accountant, and Attorney Anthony (R. 9-15).

The date for hearing the motion was twice changed for cause, first at the Government's request and then at Attorney Anthony's request.

Finally, the motion came on for hearing on May 16 (R. 61).

Though on February 20 an oral motion of like nature had been denied (R. 60), the proportions of this formal motion dictated that the matter be considered again.



The defendant first argued that under Rule 32, Federal Rules of Criminal Procedure, the motion must be granted as a matter of right. This the Court denied, holding that disposition of the matter rested in the area of judicial discretion. *United States v. Searle*, 180 F. 2d 209 (C.C.A. 7, 1950). See generally *Taylor v. United States*, 179 F. 2d 640 (C.C.A. 9, 1950), and especially the second petition for rehearing, No. 12,453 decided May 23, 1950, by the United States Court of Appeals for the Ninth Circuit.

Next it was contended the four affidavits should move the Court to grant the motion.

The Court pointed out that the only relevant affidavit was the defendant's, and that stated only conclusions. A recess was taken to allow the defendant to decide if he wished to submit evidence in support of his factual conclusions (R. 78, 79).

After the recess the defendant took the witness stand. He testified on direct examination that he had employed Hewitt & Alexander after receiving a letter from the Department of Justice. This he said was but a few days before pleading on February 9 (R. 81, 82). He further said that he talked to Hewitt several times about his plea and the amount of the tax stated in the information (this, of course, was before it was filed in Court), and that Hewitt told him, " \* \* \* I am guilty even if I owed them \$1, I am guilty just the same, so it is best to plead guilty;" (R. 82) that Hewitt never talked to defendant's bookkeeper, nor did he recommend hiring an accountant, and made no investigation prior to the date defendant plead guilty (R. 83, 95). The defendant said he had never been in Court before; that Hewitt said the information stated all the taxes he owed—but



after the plea said he owed more than that (civil liability) (R. 84). Goo said Hewitt advised him to plead guilty, as he said, "I have no other alternative but plead guilty" and that if he argued about entering "a plea" the Court, "\* \* \* he says he put me a long-term sentence \* \* \* the best for me to do is keep my mouth shut, not to say anything." (R. 85, 87). The defendant added that after plea, his accountants had discovered errors made by the United States, especially a \$23,000 item of which he was ignorant when he plead guilty; that Hewitt said that could be taken up with the Internal Revenue (R. 85, 86). Goo restated that he plead guilty because "Mr. Hewitt told me to plead guilty in this case." (R. 87). When asked the basis of his "fear, ignorance and confusion" stated in his affidavit, Goo said, "Well, according to my attorney told me that it is best for me to plead guilty rather than saying anything at all. If I do, why I going to be sentenced to a long-term prison." So he decided to follow his advice (R. 87).

Upon cross-examination Goo admitted that he received the Department of Justice tax letter in January, employed Hewitt & Alexander (R. 88) and took advantage January 19 of the hearing which the Government offered (R. 92-93). At the administrative hearing, defendant and his counsel were present, were given an opportunity to examine Goo's records which were in the Government's custody, and did so, the invitation to inspect them being one which continued even after the hearing (R. 95, 143, 159, 160, 169). When asked if after the administrative hearing and at a conference in the United States Attorney's office Hewitt had not explained to Goo the difference between crim-

inal and civil tax liability, and if he did not recall the Government then and there telling him his civil liability was between thirty-five and forty thousand dollars, the defendant testified, "No, I don't. \* \* \* I don't remember that, but I asked, \* \* \* 'Is that all the amount owing in the affidavit?', he say 'Yes, it is plainly written there' " (R. 97). He again denied remembering being told by the Government the amount of his civil liability (R. 97). Asked if his "fear" did arise after he heard the Court's statement after he had plead guilty, Goo said—twice breaking into the question, "Before that. \* \* \* Before that. \* \* \* No, the fear was before that when Attorney Hewitt told me best for me to plead guilty. I told him, 'That is not the amount I am owing, \$7,400 or \$7,500. He told me even if I am owing one dollar, I am guilty just the same, so it is best not to argue about it, that is, to keep my mouth shut' " (R. 98). Goo also denied remembering a second conference with his attorneys and Government counsel before the information was filed, at which again civil liability was distinguished from criminal, and he further denied remembering that at said conference his assets were listed to see if he could pay his civil liability (R. 98, 99). Goo claimed such occurred after his pleas, and after he discharged Hewitt & Alexander and employed new attorneys.

The defense thereupon rested, and the Government called in opposition subpoenaed witness Attorney Harry Hewitt. The defendant promptly claimed that Attorney Hewitt could not testify because the defendant claimed the attorney-client privilege and had not waived it by himself testifying (R. 103-131).

The Government, relying upon *Hunt v. Blackburn*, 128 U.S. 464 (1888), submitted (1) that the defendant waived his privilege by filing the motion charging his former attorneys with unprofessional conduct, and (2) clearly by testifying.

After due consideration of the tense point, the Court, citing *Cooper v. United States*, 5 F. 2d 824 (C.C.A. 6, 1925), ruled (1) it was not satisfied that the defendant's affidavit explicitly or clearly charged Hewitt and Alexander with unprofessional conduct, but (2) he did so in his testimony and (3) had also waived the privilege by putting in issue the exact nature of his former attorney's advice (R. 130, 131).

Accordingly, holding that the defendant by his testimony had waived his privilege, the Court allowed Hewitt to testify as to, and only as to, the advice he had given the defendant, excluding any facts coming to his knowledge from the defendant under the attorney-client relationship (R. 131, 138).

Attorney Hewitt testified that he had practiced law for thirty years, had had some tax law experience, and had been hired by Goo when the defendant received the Department of Justice letter in January, that an administrative hearing with the tax officials was had, with the defendant and his bookkeeper present, and they had an opportunity to examine defendant's books (R. 140-142). Hewitt testified that after the hearing, at Hewitt's office, with Attorney Alexander present, he said to Goo, "Alfred, how are you going to explain all of that?," whereupon the defendant threw up his hands and said, "It is no use. I



might as well give up." Hewitt stated he then asked the defendant, "Do you mean plead guilty?" to which Goo said, "Yes." (R. 143, 144). That occurred January 20, and at no time thereafter did Goo indicate that he had changed his mind about what he should do; indeed, "it never was discussed again, that is, in the way of any doubt in his mind as to what he should do." (R. 144). Hewitt stated that the Government gave him an advance copy of the information on February 6, which he at once gave to Goo, who asked to take it overnight and to discuss it with his bookkeeper; that when Goo brought it back he was asked if he had any complaint as to it, or if he had any defense to it, to which he said, "No." (R. 144). Hewitt also testified that prior to plea there was a discussion of Goo's civil liability, that Goo when told at the conference that it was thirty-five to forty thousand dollars did object that it couldn't be so high and that then and there Hewitt broke it down for him into tax and penalty and interest for the three years involved, and that Goo's assets were counted up to see if he could pay the civil bill (R. 147, 148). Hewitt denied ever telling Goo that if he argued about pleading he would get a long sentence (R. 148).

Upon cross-examination Hewitt was not examined as to his direct testimony, but an endeavor was made to reveal that Hewitt talked to the Government about this motion, before its hearing, without Goo having released him from the bond of the client's privilege. Hewitt took the position that the affidavits annexed to the motion charged him with unprofessional conduct, and hence the



mere filing of such by Goo was a waiver of the privilege (R. 150-155).

A similar situation arose when subpoenaed witness Alexander was called to testify. The Court ruled the same way, and Alexander also testified (R. 157). Although an endeavor was made by way of argument to claim Alexander contradicted Hewitt, the argument finds no support in the record unless one purposely chooses to ignore the time factor or the substance of the testimony of each. Alexander was asked by Government counsel if he or Hewitt recommended to the defendant that he should enter a plea of guilty. Alexander answered, "We did, but if I may— \* \* \* The circumstances were made after we had on several occasions attempted to elicit from the defendant an explanation of certain matters which appeared to us to be extremely condemning and extremely serious and he had refused, or failed to produce the names of witnesses or any evidence which would enable us to defend him on charges." (R. 161.) Asked if the defendant said anything about pleading, Alexander said, "I don't recall his exact statement at any time, other than I do recall his saying some words to the effect of: Well, what is the use? Or words to that effect." (R. 161.) Alexander also denied ever telling Goo to keep his mouth shut else he might go to prison for a long term, and in sum clearly described the situation as had Hewitt, especially as to Goo's knowing the difference between his criminal and civil tax liability (R. 162, 163).

William J. Doherty of the Internal Revenue Intelligence Unit testified corroborating Hewitt and Alexander as to details of the administrative

hearing and conferences attended by the defendant (R. 167-173).

The defendant presented no rebuttal.

Thereupon the parties argued the motion. During the argument the Court pointed out to defense counsel that the motion would have at least "smelled sweeter" if defendant had not endeavored to talk to the Court (*supra*) or had not had a person try to intercede with the Judge for him (*supra*) (R. 186).

At the end of the argument, passing over much that might have been said, the Court announced its ruling that the defendant had provided no basis upon which the Court could exercise its discretion in favor of the motion; therefore it was denied. June 1 was set for sentence, and the matter of the civil liability referred to again in the same language as had been used twice before—save that June 1 was fixed as the final date (R. 193-195).

In addition to the discrepancies in the appellant's testimony noted by the District Court, this Court's attention is called to the fact that when queried by his attorney as to whether he understood the difference between criminal and civil liability, the appellant said "No". Immediately afterward, when asked by the attorney for the government if he understood the difference between criminal and civil liability, the appellant said "Yes, I understand now."

It is further to be noted that the appellant was in no way induced by promises of leniency to enter a plea of guilty (R. 148) nor has the appellant alleged that any such promise was made.

Judgment and sentence were entered in this matter on June 1, 1950. Appellant was sentenced on each of the three counts contained in the indictment to pay a fine of \$1,000.00, plus costs, and was committed to the custody of the Attorney General for periods of 2 years as to Count I, 2 years as to Count II and 2 years as to Count III, Counts II and III to run concurrently (R. 30, 31, 196).

---

### SUMMARY OF ARGUMENT.

Two questions have been presented by the appellant in this appeal:

1. Under Rule 32(d) of the Rules of Criminal Procedure for the District Courts of the United States, can a defendant withdraw a plea of guilty before sentence, as a matter of right?

2. In the instant case did the District Court abuse its discretion by denying the appellant's motion to withdraw his plea of guilty?

It is respectfully submitted that the answer to each of these questions is "No".

---

### ARGUMENT.

I. DEFENDANT IS NOT ENTITLED TO WITHDRAW HIS PLEA OF GUILTY PRIOR TO SENTENCE AS A MATTER OF RIGHT.

The Act of March 8, 1934, Ch. 49, 48 Stat. 399, which authorized the Supreme Court of the United States to prescribe rules of criminal procedure for the Dis-



strict Courts of the United States provided in part as follows:

That the Supreme Court of the United States shall have the power to prescribe, from time to time, rules of practice and procedure with respect to any or all proceedings after verdict, or finding of guilt by the court if a jury has been waived, or plea of guilty, in criminal cases in district courts of the United States, including the District Courts of Alaska, Hawaii, Puerto Rico, Canal Zone, and Virgin Islands, in the Supreme Courts of the District of Columbia, Hawaii, and Puerto Rico, in the United States Court for China, in the United States Circuit Courts of Appeals, in the Court of Appeals of the District of Columbia, and in the Supreme Court of the United States: *Provided*, That nothing herein contained shall be construed to give the Supreme Court the power to abridge the right of the accused to apply for withdrawal of a plea of guilty, if such application be made within ten days after entry of such plea, and before sentence is imposed.

Pursuant to the provisions of the Act of March 8, 1934, the Supreme Court prescribed rules of criminal procedure for the District Courts of the United States which are found at 292 U.S. 661. Rule II(4) provided that:

A motion to withdraw a plea of guilty shall be made within ten (10) days after entry of such plea and before sentence is imposed.

This rule remained in effect until March 21, 1946, the effective date of the new Federal Rules of Criminal Procedure for the District Courts of the United States.



The courts uniformly held that a motion to withdraw a plea of guilty, brought under Rule II(4), was addressed to the sound discretion of the Court. *United States v. Denniston*, 89 F.(2d) 696 (1937—2 C.C.A.) certiorari denied 301 U.S. 709; *Farnsworth v. Zerbst*, 98 F.(2d) 541, 543 (1938—5 C.C.A.); *Ward v. United States*, 116 F.(2d) 135 (1940—6 C.C.A.); *United States v. Fox*, 130 F.(2d) 56 (1942—8 C.C.A.) certiorari denied 317 U.S. 666; *Farrington v. King*, 128 F.(2d) 785, 787 (1942—8 C.C.A.); *United States v. Colonna*, 142 F.(2d) 210, 211 (1944—3 C.C.A.); *Bergen v. United States*, 145 F.(2d) 181, 186 (1944—8 C.C.A.); *Swift v. United States*, 148 F.(2d) 361, 362 (1945—App. D.C.); *United States v. Mignogno*, 157 F.(2d) 839 (1946—2 C.C.A.) certiorari denied 330 U.S. 830.

As pointed out by the Appellant in his brief, pages 6 and 7, the requirement under Rule II(4) that a motion to withdraw a plea of guilty had to be made within certain time, was given jurisdictional effect by the courts. *Cooke v. Swope*, 109 F.(2d) 955 (1940—9 C.C.A.); *United States v. Achtner*, 144 F.(2d) 49 (1944—2 C.C.A.). It is apparent that Rule II(4) could frequently result in severe injustice to a defendant, particularly when newly discovered evidence was turned up after the defendant had been sentenced, or more than ten days after he had entered his plea. Having given the time limit set forth in the rule jurisdictional weight, a court could not entertain a motion to withdraw the plea if not timely filed and there was some doubt as to whether such a

situation could be remedied by the filing of a petition for a writ of error *coram nobis*. In this connection see *United States v. Norstrand Corporation et al.*, 168 F.(2d) 481, 482 (1948—2 C.C.A.). Comments on the harshness of the old rule, directed primarily to the fact that the rule deprived a Court of jurisdiction to correct a manifest injustice unless that injustice were called to the attention of the Court within the period of time specified in the rule, are found in the following cases and articles: *United States v. Achtner*, supra, page 52; *Swift v. United States*, supra, page 362; *Von Moltke v. Gillies*, 161 F. (2d) 113, 116 (1947—6 C.C.A.) rev'd 332 U.S. 708; “*Improving Procedure on Judgment and Appeal in Federal Criminal Cases*,” Lester B. Orfield, 2 F.R.D. 573, 577 (1942); *Federal Rules of Criminal Procedure with Notes and Proceedings*, New York University School of Law, 1946, p. 227.

Congress in the Act of June 29, 1940, Chapter 445, 54 Stat. 688, 18 U.S.C. Sec. 687, authorized the Supreme Court of the United States to prescribe rules of criminal procedure for the District Courts of the United States. The proviso contained in the Act of March 8, 1934, “. . . that nothing herein contained shall be construed to give the Supreme Court the power to abridge the right of the accused to apply for withdrawal of a plea of guilty, if such application be made within ten days after entry of such plea, and before sentence is imposed” was omitted from the Act of June 29, 1940. In Rule 32(d) of the new Federal Rules of Criminal Procedure, which became effective on March 21, 1946, it is provided that:

A motion to withdraw a plea of guilty of or *nolo contendere* may be made only before sentence is imposed or imposition of sentence is suspended; but to correct manifest injustice the Court after sentence may set aside the judgment of conviction and permit the defendant to withdraw his plea.

The Appellant has endeavored to work out through a comparison of Rule II(4) of the old Rules of Criminal Procedure and Rule 32(d) of the New Rules of Criminal Procedure a tortuous theory that under Rule 32(d) a defendant may withdraw a plea of guilty as a matter of right at any time prior to sentence (Appellant's Brief, p. 8, et seq.). To do this, he refers to the following quotation from an address given by Professor Lester B. Orfield on August 25, 1942, 2 F.R.D. 573, 577:

\* \* \* The present Rule II(4) provides that a motion to withdraw a plea of guilty must be made within ten days after entry of such plea. Is not this an undue hardship on the defendant, and should we not adopt the rule now prevalent in many states which permits withdrawal of the plea at any time before sentence?

The following note accompanies that statement and query:

Sec. 230 of the American Law Institute Code of Criminal Procedure (1930) goes even further and permits setting aside of a judgment so that the plea may be withdrawn.

The Appellant points out that several courts had commented upon the harshness of Rule II(4) and



noted that the Advisory Committee on Rules of Criminal Procedure, of which Professor Orfield was a member, had recommended a substantially more liberal rule. The Appellee does not contend that Rule 32(d) is not more liberal than the old rule, II(4), but it is apparent that the increased liberality extends only to the time within which a defendant may apply for leave to withdraw his guilty plea and does not deprive the Court of its discretion in the matter before sentence.

If the advisory Committee on Rules of Criminal Procedure or the Supreme Court had intended to give a defendant the right to withdraw his plea of guilty at any time prior to sentence, they certainly would have used language which more clearly expressed that intent. It would have been a simple matter to have phrased the rule thusly:

A plea of guilty or of *nolo contendere* may be withdrawn at any time before sentence is imposed or imposition of sentence is suspended, and to correct manifest injustice the Court, after sentence, may set aside the judgment of conviction and on proper motion permit the defendant to withdraw his plea.

As a matter of fact, Rule 32(d) as promulgated by the Supreme Court is identical with the rule proposed by the Advisory Committee, Rule 34(d) found in the Second Preliminary Draft of Rules of Criminal Procedure.<sup>1</sup> In the note to Rule 34(d) of the

---

<sup>1</sup>*Federal Rules of Criminal Procedure, Second Preliminary Draft*, February 1944. U.S. Government Printing Office, Washington, D.C.



Second Preliminary Draft of Rules of Criminal Procedure, reference is made to the fact that "Numerous states permit a plea of guilty to be withdrawn and other pleas to be substituted at any time before judgment. See, e.g., Iowa Code (1939) § 13803; Minn. Stat. (1941) § 630.29; Wash. Rev. Stat. Ann. (Remington, 1932) § 2111."

Judge Holtzoff in discussing Rule 32(d) of the new Federal Rules of Criminal Procedure, made the following statement on February 16, 1946: "Under the present rules (Rule II(4) of the old rules) there is a time limitation on motions to withdraw a plea of guilty. We have substituted the rule that at any time prior to sentence, the Court *at its discretion* may grant such permission, and even after sentence, in extreme cases, it may do so."<sup>2</sup> (Emphasis supplied.)

It is apparent from the foregoing that while Professor Orfield desired that the new rules should grant a defendant the right to withdraw a plea of guilty at any time prior to sentence, his recommendation was neither adopted by the Advisory Committee nor by the Supreme Court. In this connection, it is to be noted that Professor Orfield's statement and query quoted above was made in 1942 before the Advisory Committee had prepared its draft of the new Federal Rules of Criminal Procedure.

On the issue of whether a defendant may withdraw a plea of guilty prior to sentence as a matter of right or whether such a motion is addressed to the sound

---

<sup>2</sup>*Federal Rules of Criminal Procedure with Notes and Proceedings*, New York University School of Law, 1946, p. 227.

discretion of the District Court, this is apparently a case of first impression. Other cases arising under Rule 32(d) have uniformly held that a motion to withdraw a plea of guilty filed after sentence is addressed to the Court's discretion. *Taylor v. United States*, 179 F.(2d) 640, certiorari denied 339 U.S. 988, 2nd pet. for rehearing den., 180 F.(2d) 1020 (1950—9 C.A.); *Collins v. United States*, 176 F.(2d) 773, 776, 777 (1949—9 C.A.), certiorari denied 338 U.S. 943; *United States v. Mignogna*, supra; *Stidham v. United States*, 170 F.(2d) 294 (1948—8 C.C.A.); *United States v. Harris*, 160 F.(2d) 507 (1947—2 C.C.A.); *United States v. Searle*, 180 F.(2d) 209 (1950—7 C.A.); *United States v. Lias*, 173 F.(2d) 685 (1949—4 C.A.).

---

## II. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION BY DENYING THE APPELLANT'S MOTION TO WITHDRAW HIS PLEA.

The courts have reiterated again and again the injunction of the Supreme Court in *Kercheval v. United States*, 274 U.S. 220 (1927) that pleas of guilty are to be accepted only with caution and that a defendant entering such a plea should be permitted to withdraw it if it was made through ignorance, fear or inadvertence. The Appellant has cited numerous cases in which the courts have considered whether a motion to withdraw a guilty plea should be allowed. In support of these motions, the defendants have urged that they were deprived of constitutional rights, *Farnsworth v. Zerbst*, supra; that they lacked

the assistance of counsel, *Cooke v. Swope*, supra; *Jackson v. United States*, 131 F.(2d) 606 (1942—8 C.C.A.); that they had been fraudulently induced to enter a plea of guilty, *Ward v. United States*, supra; *United States v. Fox*, supra; *United States v. Bayaud*, 23 Fed. 721 (1883); that the indictment was insufficient, *Scheff v. United States*, 33 F.(2d) 263 (1929—8 C.C.A.); *Roberto v. United States*, 60 F.(2d) 774 (1932—7 C.C.A.); that he had been misadvised by counsel, did not know what he was doing, and that he was not guilty, *Gleckman v. United States*, 16 F.(2d) 670 (1926—8 C.C.A.). While these are elements which are always to be taken into consideration by a court in determining whether to grant or to deny a motion to withdraw a guilty plea, it will be found that in the vast majority of such cases the motion to withdraw the plea has been denied. This is undoubtedly because the District Courts have been faithful to the Supreme Court's warning and have accepted guilty pleas only with caution in the first place.

In *Bergen v. United States*, supra, the Court, after ruling that the withdrawal of a plea of guilty is within the discretion of the Court and is not a matter of right, laid down the following standards which should be met before a guilty plea is accepted and which, if they have been met, will cause a court to deny a motion to withdraw the plea:

An intelligent and full understanding by the accused is a first requirement of due process. . . . Circumstances important for consideration are the nature of the charge against the accused,



his apparent intelligence and ability to fully comprehend the charges against him, the gravity of the offense charged, the timeliness of the motion to withdraw the plea (this was under the old rule), and the fact that the accused before entering his plea did not have the advice of counsel.

In this case the Appellant had the advice of counsel and had a full understanding of the charges against him. His claim that he entered the plea under duress and that he did not know what he was doing was considered by the trial judge and was found to be unsupported by the evidence (R. 193).

While the appellant moved the District Court to grant him leave to withdraw his plea of guilty prior to sentence, an examination of the record reveals it was only after he realized that he was not going to receive a lenient sentence, that the Court would probably send him to jail, that he obtained new counsel and moved to withdraw his plea of guilty. The courts have uniformly held that such a discovery on the part of a defendant does not constitute sufficient grounds for the granting of a motion to withdraw a guilty plea. *United States v. Colonna*, supra; *United States v. Norstrand Corporation et al.*, supra, p. 482.

To permit a defendant to wait until he can gauge the severity of the sentence would enable him to trifle with the Court, and the Courts through their discretionary powers in the allowance or disallowance of a motion to withdraw a guilty plea, gain their only protection from such trifling. *United States v. Harris*, supra.



The very least that a defendant should do if he desires to withdraw a plea of guilty is to allege that he is not guilty of the charge to which he pleaded. *United States v. Norstrand Corporation et al.*, supra. In the instant case, the Appellant made divers allegations that he was not familiar with court procedure, that he had been advised by his former counsel to plead guilty and did not know what he was doing, and that later he felt he had made a mistake in pleading guilty. This was after he was advised by the Court he would probably be sent to jail. He further alleged in his motion and testified on the stand that there might be a carry-back from a loss sustained in 1946 which would wipe out the taxes due in 1945 and perhaps part of those due in 1944. His allegations that he did not understand what he was doing, that his counsel had advised him to plead guilty, and other allegations indicating that his plea was not voluntarily and intelligently made were completely rebutted by the testimony of Mr. Hewitt, Mr. Alexander and Mr. Doherty. His allegation that because of a possible carry-back he did not owe any taxes for the year 1945 and for part of 1944 is no defense to the criminal charge and consequently was not material to the Appellant's motion to withdraw his guilty plea. The offense charged in each count of the information is completed on the day the tax return is filed, and subsequent reductions in the taxpayer's liability resulting from the carrying back of a loss do not make his return any the less fraudulent. *Manning v. Seeley Tool and Box Company*, 338 U.S. 561, 565 (1950).

In short, the Appellant did not in his motion to withdraw his guilty plea, or in his testimony from the stand, allege that he was not guilty of the charges contained in the Information, nor did he advance a theory on which a defense to that Information could be premised.

Under these circumstances, and considering the record which reveals clearly that the Appellant understood the nature of the charges and acted intelligently when he entered his plea of guilty, it is submitted that the District Court did not abuse its discretion when it denied the Appellant leave to withdraw his guilty plea.

---

#### CONCLUSION.

For the foregoing reasons, it is respectfully submitted that the judgment and sentence of the trial court should be affirmed.

Dated, Honolulu, T. H.,

December 6, 1950.

Respectfully submitted,

RAY J. O'BRIEN,

United States Attorney, District of Hawaii,

HOWARD K. HODDICK,

Assistant United States Attorney, District of Hawaii,

FRANK J. HENNESSY,

United States Attorney,

*Attorneys for Appellee.*













